

### INTRODUCTION

A construction loan is used to finance the construction of a particular project within a specified period of time and is funded by supervised disbursements of a predetermined amount over the construction period. When properly controlled, a bank can promote commercial or residential development through its construction lending as well as receive significant profits over a relatively short time frame. However, the higher rate of return demanded by construction lenders is indicative of the higher risks assumed.

Inasmuch as construction lending is a form of interim financing, loan repayment is contingent upon the borrower either obtaining permanent financing or finding a buyer with sufficient funds to purchase the completed project. Because many borrowers anticipate retaining ownership after construction, the cost and availability of funds from permanent financing is a primary factor to be considered by the bank in assessing the risk of a construction loan.

A construction loan is generally secured by a first mortgage or deed of trust on the land and improvements, which is often backed by a purchase agreement from a financially sound investor or by a takeout financing agreement from a responsible permanent lender. A long-term mortgage loan (permanent financing) is typically obtained prior to or simultaneous with the construction loan and is made to refinance the short-term construction loan. Additionally, the bank may require a borrower to provide secondary collateral in the form of a junior interest in another real estate project or a personal guarantee.

### BANK LENDING POLICY

Banks can limit the risk inherent in construction lending by establishing policies that specify the type and extent of bank involvement. The bank's lending policies should reflect prudent lending standards and set forth pricing guidelines, limits on loan-to-value ratios and debt-coverage ratios, and yield requirements. Such policies should also address procedures relative to controlling disbursements in a manner that is commensurate with the construction progress.

### Lending Limits

A bank should have established and well-controlled construction lending limits that are within the acceptable standards of state banking regulations. State banking statutes governing construction lending may contain minimum standards of prudence without specifying actual loan terms.

The bank's internal limits should not exceed the supervisory loan-to-value (LTV) limits set forth in the Interagency Guidelines for Real Estate Lending Policies, as required by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and included as appendix C of the Federal Reserve's Regulation H. These guidelines, and the accompanying LTV limits, are discussed in the Real Estate Loans section of this manual. Generally, the LTV ratio should not exceed the following supervisory limits:

- 65 percent for raw land loans;
- 75 percent for land development and improved land loans;
- 80 percent for commercial, multifamily, and other nonresidential construction loans; and
- 85 percent for one- to four-family residential construction loans.

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project.

### Lending Risks

Construction loans are vulnerable to a wide variety of risks. Critical to the evaluation of any construction loan is the analysis of the project's feasibility study to ascertain the developer's risk, which affects the lender's risk. The major portion of the risk is attributable to the need to complete a project within specified cost and time limits. Examples of difficulties that may arise include:

- Completion of a project after takeout dates, which voids permanent funding commitments.

- Cost overruns, which may exceed takeout commitments or sale prices.
- The possibility that the completed project will be an economic failure.
- The diversion of progress payments resulting in nonpayment of material bills or subcontractors.
- A financial collapse of or the failure of the contractors, subcontractors, or suppliers to perform before the completion date.
- Increased material or labor costs.
- The destruction of improvements from unexpected natural causes.
- An improper or lax monitoring of funds advanced by the bank.

## TYPES OF CONSTRUCTION LOANS

The basic types of construction lending are unsecured front money, land development, residential construction, and commercial construction loans. It is not uncommon for a bank to provide the acquisition, development, and construction loans for a particular project.

### Unsecured Front Money Loans

Front money loans are considered very risky and should not be undertaken unless the bank has the expertise to evaluate the credit risk. These loans may represent working capital advances to a borrower who may be engaged in a new and unproven venture. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and meet minimum working capital requirements established by construction lenders. Because repayment often comes from the first draw against construction financing, many construction loan agreements prohibit the use of the first advance to repay nonconstruction costs. Unsecured front money loans used as a developer's equity investment in a project or to cover initial cost overruns are symptomatic of an undercapitalized or possibly an inexperienced or inept builder.

### Land Development Loans

Land development or off-site improvement loans are intended to be secured-purchase loans or

unsecured advances to creditworthy borrowers. A development loan involves the purchase of land and lot development in anticipation of further construction or sale of the property. In addition to funding the acquisition of the land, a development loan may be used to fund the preparation of the land for future construction, including the grading of land, installation of utilities, and construction of streets.

Effective administration of a land development loan begins with a plan defining each step of the development. The development plan should incorporate cost budgets, including legal expenses for building and zoning permits, environmental impact statements, costs of installing utilities, and all other projected costs of the development. Bank management's review of the plan and related cost breakdowns should provide the basis for determining the size, terms, and restrictions for the development loan. Refer to the subsection below on the assessment of real estate collateral for further discussion.

The LTV ratio should provide for sufficient margin to protect the bank from unforeseen events (such as unplanned expenses) that would otherwise jeopardize the bank's collateral position or repayment prospects. If the loan involves the periodic development and sale of portions of the property under lien, each separately identifiable section of the project should be independently appraised and any collateral should be released in a manner that maintains a reasonable margin. The repayment program should be structured to follow the sales or development program. Control over development loans can be best established when the bank finances both the development and the construction or sale phases of the project.

In the case of an unsecured land development loan, it is essential to analyze the borrower's financial statements to determine the source of loan repayment. In establishing the repayment program, the bank should review sales projections to ensure that they are not overly optimistic. Additionally, banks should avoid granting loans to illiquid borrowers or guarantors who provide the primary support for a borrower (project).

### Residential Construction Loans

Residential construction loans are made either on a speculative basis, where homes are built to

be sold later in the general market, or for a specific buyer with prearranged permanent financing. Loans financing residential projects that do not have prearranged homebuyer financing are usually limited to a predetermined number of speculative homes, which are permitted to get the project started. However, smaller banks are often engaged in this type of financing and the aggregate total of individual speculative construction loans may equal a significant portion of their capital funds. It is important to ensure that the homebuyer has arranged permanent financing before the bank finances the construction; otherwise, the bank may find itself without a source of repayment. Construction loans without permanent takeout commitments generally should be aggregated to determine whether a concentration of credit exists, that is, in those situations when the amount exceeds 25 percent of the bank's capital structure (tier 1 capital plus loan loss reserves).

Proposals to finance speculative construction should be evaluated according to predetermined policies that are compatible with the institution's size, the technical competence of its management, and the housing needs of its service area. The prospective borrower's reputation, experience, and financial condition should also be reviewed to assess the likelihood of completing the proposed project. Until the project is completed, the actual value of the real estate is questionable. Thus, the marketability of the project should be substantiated in a feasibility study, reflecting a realistic assessment of current favorable and unfavorable local housing market conditions. As in any real estate loan, the bank must also obtain an appraisal or evaluation for the project. The appraisal or evaluation and the feasibility study are important tools to be used by lenders in evaluating project risks. For projects located out of area, the lender may lack market expertise, which makes evaluating the reasonableness of the marketing plan and feasibility study more difficult, and therefore makes the loan inherently riskier.

A bank dealing with speculative builders should have control procedures tailored to the individual project. A predetermined limit on the number of unsold units to be financed at any one time should be included in the loan agreement to avoid overextending the builder's capacity. The construction lender should receive current inspection reports indicating the project's progress. In some instances, the construction lender is also the permanent mortgagor. Loans on larger resi-

dential construction projects are usually negotiated with prearranged permanent financing as part of the construction loan.

## Commercial Construction Loans

A bank's commercial construction lending activity can encompass a wide range of projects—apartments, condominiums, office buildings, shopping centers, and hotels—with each requiring a special set of skills and expertise to successfully manage, construct, and market.

Commercial construction loan agreements should normally require the borrower to have a precommitted extended-term loan to “takeout” the construction lender. Takeout financing agreements, however, are usually voidable if construction is not completed by the final funding date, if the project does not receive occupancy permits, or if the preleasing or occupancy rate does not meet an agreed-upon level. A bank can also enter into an “open-end” construction loan where there is no precommitted source to repay the construction loan. Such loans pose an added risk because the bank may be forced into providing permanent financing, oftentimes in distressed situations. In evaluating this risk, the bank should consider whether the completed project will be able to attract extended-term financing, supportable by the projected net operating income.

The risk of commercial construction requires a complete assessment of the real estate collateral, borrower's financial resources, source of the extended-term financing, and construction plans. As in any real estate loan, the bank must obtain an appraisal or evaluation of the real estate in accordance with the Federal Reserve's appraisal regulation. Additionally, the borrower should provide a feasibility study for the project that details the project's marketing plan, as well as an analysis of the supply-and-demand factors affecting the projected absorption rate. For an open-end construction loan, the feasibility study is particularly important to the bank's assessment of the credit because the repayment of the loan becomes increasingly dependent on the sales program or leasing of the project.

The bank also needs to assess the borrower's development expertise, that is, whether the borrower can complete the project within budget and according to the construction plans. The financial risk of the project is contingent on the

borrower's development expertise because the source of the extended-term loan may be predicated upon a set date for project completion. Until the project is completed, the actual value of the real estate is questionable.

A bank may reduce its financial risk by funding the construction loan after the borrower has funded its share of the project equity (for example, by paying for the feasibility study and land acquisition and development costs). An alternative approach would require the borrower to inject its own funds into the project at agreed-upon intervals during the project's management, construction, and marketing phases to coincide with the construction lender's contributions. In larger projects, equity injections can be provided by equity partners or joint ventures. These can take the form of equity syndications,<sup>1</sup> whose contributions are injected in the project in phases. A bank should assess the likelihood of the syndication being able to raise the necessary equity.

## BANK ASSESSMENT OF THE BORROWER

The term "borrower" can refer to different types of entities. These forms can range from an entity whose sole asset is the project being financed to an entity that has other assets available to support the debt in addition to the project being financed (a multi-asset entity).

Although the value of the real estate collateral is an important component of the loan approval process, the bank should not place undue reliance on the collateral value in lieu of an adequate analysis of the borrower's ability to repay the loan. The analytical factors differ depending on the purpose of the loan, such as residential construction versus the various types of commercial construction loans.

The bank's analysis is contained in its documentation files, which should include background information on the borrower and partner/guarantor concerning their character and credit

history, expertise, and financial statements (preferably audited) for the most recent fiscal years. Background information regarding a borrower's and partner's/guarantor's character and credit history is based upon their work experience and previous repayment practices, both relative to trade creditors and financial institutions. The documentation files should indicate whether the borrower has demonstrated it can successfully complete the type of project to be undertaken. The financial statements should be analyzed to ensure that the loan can be repaid in the event that a takeout does not occur.

The degree of analysis depends on whether the borrower is in reality a single-asset entity or a multi-asset entity. A loan to a single-asset entity is often predicated upon the strength of the partners/guarantors. Accordingly, understanding their financial strength, which frequently is made up of various partnership interests, is key to assessing the project's strength. In this example, it would be necessary to obtain financial information on the partner's/guarantor's other projects, even those not financed by the bank, to understand their overall financial condition. This is necessary because other unsuccessful projects may cause financial trouble for the partner/guarantor, despite a successful sales program by the bank's borrower. Issues to be considered, in addition to those raised in the preceding paragraph, include the vacancy rates of the various projects, break-even points, and rent rolls.

A loan to a multi-asset entity has similar characteristics to those found in the single-asset entity, in that it is necessary to evaluate all of the assets contained therein to ascertain the actual financial strength. In both cases, assessment of the project under construction would include preleasing requirements. For a loan with a takeout commitment, the financial strength and reputation of the permanent lender should be analyzed. For a loan without a takeout commitment, or one where the construction lender provides the permanent financing for its construction loan, the long-term risks also need to be evaluated. Refer to the Real Estate Loans section in this manual, on the bank's assessment of the borrower, for additional factors to be considered.

In instances where approval for the loan is predicated upon the strength of entities other than the borrower (partner/guarantor), the bank should obtain information on their financial condition, income, liquidity, cash flow, contingent liabilities, and any other relevant factors

1. Syndication generally refers to the act of bringing together a group of individuals or entities to invest in a real estate project and does not refer to any particular legal form of ownership. The legal form varies depending on the investors' investment objectives, division of tax benefits, responsibility for project management, and desire to limit personal liability. The investment vehicle may be a general partnership, limited partnership, joint venture, tenancy in common, corporation, real estate investment trust, and common law trust.

that exist to demonstrate their financial capacity to fulfill the obligation in the event that the borrower defaults.

Partners/guarantors generally have investments in other projects included as assets on their financial statements. The value of these investments frequently represents the partner's/guarantor's own estimate of the investment's worth, as opposed to a value based upon the investment's financial statements. As a result, it is necessary to obtain detailed financial statements for each investment to understand the partner's/guarantor's complete financial picture and capacity to support the loan. The statements should include detailed current and accurate cash flow information since cash flow is often the source of repayment.

It is also important to consider the number and amount of the guarantees currently extended by a partner/guarantor to determine if they have the financial capacity to fulfill the contingent claims that exist. Furthermore, the bank should review the prior performance of the partner/guarantor to voluntarily honor the guarantee as well as the marketability of the assets collateralizing the guarantee. Since the guarantee can be limited to development and construction phases of a project, the bank should closely monitor the project before issuing a release to the partner/guarantor.

## BANK ASSESSMENT OF REAL ESTATE COLLATERAL

Banks should obtain an appraisal or evaluation, as appropriate, for all real estate-related financial transactions prior to making the final credit or other decision. Refer to the Real Estate Appraisals and Evaluations section of this manual for a description of the related requirements a bank must follow for real estate-related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches.

The appraisal or evaluation techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The aggregate principal amount of the loan should be based on an appraisal or evaluation that provides, at a mini-

mum, the "as is" market value of the property.<sup>2</sup> Additionally, the bank will normally request the appraiser to report the "as completed" value.<sup>3</sup> Projections should be accompanied by a feasibility study explaining the effect of projected property improvements on the market value of the land. The feasibility study may be a separate report or incorporated into the appraisal report. If the appraiser uses the feasibility study, the appraiser's acceptance or rejection of the study and its effect on the value should be fully explained in the appraisal.

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale in accepting and relying upon the appraisal or evaluation should be in writing and made a part of loan documentation. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the bank may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation. Since the approval of the loan is based upon the value of the project after the construction is completed, insofar as the value component of the loan-to-value ratio is concerned, it is important for the bank to closely monitor the project's progress (value) during the construction period. Refer to the Real Estate Loans section of the manual for additional information relative to the real estate collateral assessment.

## LOAN DOCUMENTATION

The loan documentation should provide infor-

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2. The "as is" value is the value of the property in its current physical condition and subject to the zoning in effect as of the date of appraisal.

3. The "as completed" value reflects the value of the land and the projected improvements. A bank may also request a value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development. For proposed residential developments that involve the sale of individual houses, units, or lots, the appraisal should reflect deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. For proposed and rehabilitated income-producing properties, the appraisal should reflect appropriate deductions and discounts for leasing commissions, rent losses, and tenant improvements from the estimated value based on stabilized occupancy.

mation on the essential details of the loan transaction, the security interest in the real estate collateral, and the takeout loan commitment, if any. The necessary documentation before the start of construction generally includes:

- Financial and background information on the borrower to substantiate the borrower's expertise and financial strength to complete the project.
- The construction loan agreement, which sets forth the rights and obligations of the lender and borrower, conditions for advancing funds, and events of default. In some states, the agreement must be cited in either the deed of trust or the mortgage.
- A recorded mortgage or deed of trust, which can be used to foreclose and to obtain title to the collateral.
- A title insurance binder or policy, usually issued by a recognized title insurance company or, in some states, an attorney's opinion. The title should be updated with each advance of funds to provide additional collateral protection.
- Insurance policies and proof of payment as evidence that the builder has adequate and enforceable coverage for liability, fire and other hazards, and vandalism and malicious mischief losses.
- An appropriate appraisal or evaluation showing the value of the land and improvements to date or, possibly, a master appraisal based on specifications for a multiphase development.
- Project plans, a feasibility study, and a construction budget showing the development plans, project costs, marketing plans, and equity contributions. A detailed cost breakdown of land and "hard" construction costs, as well as indirect or "soft" costs for construction loan interest, organizational and administration cost, and architectural, engineering, and legal fees should be included.
- Property surveys, easements, an environmental impact report, and soil reports that indicate construction is feasible on the selected development site. The bank should also obtain the architect's certification of the plan's compliance with all applicable building codes and zoning, environmental protection, and other government regulations, as well as the engineer's report on compliance with building codes and standards. If internal expertise is not available, a bank may need to retain an independent construction expert to review

these documents to assess the reasonableness and appropriateness of the construction plans and costs.

- The takeout commitment from the permanent lender, if applicable, and the terms of the loan. The bank should verify the financial strength of the permanent lender to fund the takeout commitment.
- A completion or performance bond signed by the borrower that guarantees the borrower will apply the loan proceeds to the project being financed.
- An owners' affidavit or a borrowing resolution empowering the borrower or its representative to enter into the loan agreement.
- Evidence that property taxes have been paid to date.

These documents furnish evidence that the lending officer is obtaining the information necessary for processing and servicing the loan and protect the bank in the event of default.

### Documentation for Residential Construction Loans on Subdivisions

The documents mentioned above are usually available for residential construction loans on subdivisions (tracts). Documentation of tract loans frequently includes a master note in the gross amount of the entire project, and a master deed of trust covering all of the land involved in the project. In addition to an appraisal or evaluation for each type of house to be constructed, the bank should also obtain a master appraisal including a feasibility study for the entire development. The feasibility study compares the projected demand for housing against the anticipated supply of housing in the market area of the proposed tract development. This analysis should indicate whether there will be sufficient demand for the developer's homes given the project's location, type of homes, and unit sales price.

### Documentation for the Takeout Commitment

Most construction lenders require the developer to have an arrangement for permanent financing for each house to be constructed. Exceptions include model homes, typically one for each style of home offered, and a limited number

of housing starts ahead of sales (speculative houses). The starts ahead of sales, however, contain additional risk. If the bank finances too many houses without purchase contracts, and housing sales decline rapidly, it may have to foreclose on the unsold houses and sell them for less than their loan value. A takeout of this type is usually an arrangement between the developer and a permanent mortgage lender, but construction lenders may also finance the permanent mortgages.

The essential information required for a commercial real estate takeout to proceed includes the floor and ceiling rental rates and minimum occupancy requirements; details of the project being financed; expiration date; standby fee requirement; assignment of rents; and, generally, a requirement that the construction loan be fully disbursed and not in any way in default at the time settlement occurs.

The commitment agreement, referred to as the buy/sell contract or the tri-party agreement, is signed by the borrower, the construction lender, and the permanent lender. The purpose of this agreement is to permit the permanent lender to buy the loan directly from the construction lender upon completion of the construction, with the stipulation that all contingencies have been satisfied. Examples of contingencies include project completion by the required date, clear title to the property, and minimum lease-up requirements. A commitment agreement also protects the construction lender against unforeseen possibilities, such as the death of a principal, before the permanent loan documents are signed.

## ADMINISTERING THE LOAN

The bank and the borrower<sup>4</sup> must effectively cooperate as partners if controls relative to construction progress are to be maintained. The loan agreement specifies the performance of each party during the entire course of construction. Any changes in construction plans should be approved by both the construction lender and

the takeout lender. Construction changes can result in increased costs, which may not necessarily increase the sale value of the completed project. On the other hand, a decrease in costs may not indicate a savings but may suggest the use of lesser quality materials or workmanship, which could affect the marketability of the project.

## Disbursement of Loan Funds

Loan funds are generally disbursed through either a stage payment plan or a progress payment plan. Regardless of the method of disbursement, the amount of each construction draw should be commensurate with the improvements made to date. Funds should not be advanced unless they are used in the project being financed and as stipulated in the draw request. Therefore, the construction lender must monitor the funds being disbursed and must be assured, at every stage of construction, that sufficient funds are available to complete the project.

### *Stage Payment Plan*

The stage payment plan, which is normally applied to residential and smaller commercial construction loans, uses a preestablished schedule for fixed disbursements to the borrower at the end of each specified stage of construction. The amount of the draw is usually based upon the stage of development because residential housing projects normally consist of houses in various stages of construction. Nevertheless, loan agreements involving tract financing typically restrict further advances in the event of an accumulation of completed and unsold houses. Disbursements are made when construction has reached the agreed-upon stages, verified by an actual inspection of the property. These typically include advances at the conclusion of various stages of construction, such as the foundation, exterior framing, the roof, interior finishing, and completion of the house. The final payment is made after the legally stipulated lien period for mechanic's liens has lapsed.

Disbursement programs of this type are usually required for each house constructed within a tract development. As each house is completed and sold, the bank makes a partial release relative to that particular house covered by its

4. The borrower may not be the entity responsible for the actual construction of the project. Depending on the size, type, and complexity of the project, the borrower may strictly be a developer who assembles the land, designs the project, and contracts with a construction company to handle the actual construction of the building. If this is the case, the bank should obtain financial and project history information on the builder/contractor.

master deed of trust. The amount of the release is set forth in the loan agreement, which specifies the agreed-upon release price for each house sold with any excess over the net sales proceeds remitted to the borrower.

### *Progress Payment Plan*

The progress payment plan is normally used for commercial projects.<sup>5</sup> Under a progress payment system, funds are released as the borrower completes certain phases of construction as agreed upon in the loan agreement. Normally, the bank retains a percentage of the funds as a hold back (or retainage) to cover project cost overruns or outstanding bills from suppliers or subcontractors. Hold backs occur when a developer/contractor uses a number of subcontractors and maintains possession of a portion of the amounts owed to the subcontractors during the construction period. This is done to ensure that the subcontractors finish their work before receiving the final amount owed. Accordingly, the construction lender holds back the same funds from the developer/contractor to avert the risk of their misapplication or misappropriation.

The borrower presents a request for payment from the bank in the form of a “construction draw” request or “certification for payment,” which sets forth the funding request by construction phase and cost category for work that has been completed. This request should be accompanied by receipts for the completed work (material and labor) for which payment is being requested. The borrower also certifies that the conditions of the loan agreement have been met—that all requested funds have been used in the subject project and that suppliers and subcontractors have been paid. Additionally, the subcontractors and suppliers should provide the bank with lien waivers covering the work com-

pleted for which payment has been received. Upon review of the draw request and independent confirmation on the progress of work, the bank will disburse funds for construction costs incurred, less the hold back. The percentage of the loan funds retained are released when a notice of the project’s completion has been filed, and after the stipulated period has elapsed under which subcontractors or suppliers can file a lien.

### **Monitoring Progress of Construction and Loan Draws**

It is critical that a bank has appropriate procedures and an adequate tracking system to monitor payments to ensure that the funds requested are appropriate for the given stage of development. The monitoring occurs through physical inspections of the project once it has started. The results of the inspections are then documented in the inspection reports, which are kept in the appropriate file. Depending on the complexity of the project, the inspection reports can be completed either by the lender or by an independent construction consulting firm, the latter generally staffed by architects and engineers. The reports address both the quantity and the quality of the work for which funds are being requested. They also verify that the plans are being followed and that the construction is proceeding on schedule and within budget.

The bank must be accurately informed of the progress to date in order to monitor the loan. It is also important that the bank ascertain whether draws are being taken in accordance with the predetermined disbursement schedule. Before any draw amount is disbursed, however, the bank must obtain verification of continued title insurance. Generally, this means verifying that no liens have been filed against the title of the project since the previous draw. The title insurance insuring the construction lender’s mortgage or lien is then increased to include the new draw, which results in an increase in the title insurance commensurate with the disbursement of funds. The lender frequently examines title to the property securing the construction loan to also be certain that the borrower is not pledging it for other borrowings and to be sure that mechanic’s liens are not being filed for unpaid bills. When the project is not proceeding as anticipated, that fact should be reflected in the inspection reports.

5. Other methods for disbursing commercial construction loans include the voucher system and the monthly draw method. The voucher system is similar to the progress system except that borrower prepares a voucher of all invoices to be paid with signatures of the subcontractors attesting to the invoiced amount. The bank then issues checks directly to the subcontractors or suppliers. The monthly draw method is used in long-term projects wherein the borrower makes a draw request each month for the previous month’s work. In turn, the bank determines the amount of work completed to date and releases funds based on the value of work completed versus the value of the work remaining.



Another important component in the process is the ongoing monitoring of general economic factors that will affect the marketing and selling of the residential or commercial properties and affect their success upon completion of the project.

### *Monitoring Residential Projects*

An inventory list is maintained for each tract or phase of the project. The inventory list should show each lot number, the style of house, the release price, the sale price, and the loan balance. The list should be posted daily with advances and payments indicating the balance advanced for each house, date completed, date sold, and date paid, and should age the builder's inventory by listing the older houses completed and unsold.

Inspections (usually monthly) during the course of construction of each house should be documented in progress reports. The progress report should indicate the project's activity during the previous month, reflecting the number of homes under construction, the number completed, and the number sold. The monthly report should indicate whether advances are being made in compliance with the loan agreement.

### *Monitoring Commercial Projects*

To have an effective control over its commercial construction loan program, the bank must have an established loan administration process that continually monitors each project. The process should include monthly reporting on the work completed, the cost to date, the cost to complete, construction deadlines, and loan funds remaining. Any changes in construction plans should be documented and reviewed by the construction consulting firm and should be approved by the bank and takeout lender. A significant number of change orders may indicate poor planning or project design, or problems in construction, and should be tracked and reflected in the project's budget. Soft costs such as advertising and promotional expenses normally are not funded until the marketing of the project has started.

## Final Repayment

Before the final draw is made, the construction

loan should be in a condition to be converted to a permanent loan. Usually the final draw includes payment of the hold back stipulated in the loan agreement and is used to pay all remaining bills. The bank should obtain full waivers of liens (releases) from all contractors, subcontractors, and suppliers before the loan is released and the hold back is disbursed. The bank should also obtain a final inspection report to confirm the project is completed and meets the building specifications, including confirmation of the certificate of occupancy from the governing building authority.

Sources of permanent funding for commercial projects vary greatly, depending upon the type of project. For condominium projects, the construction lender may also be providing the funding for marketing the individual units and would be releasing the loan on a unit-by-unit basis similar to a residential development construction loan. If there is a precommitted takeout lender, the new lender could purchase the construction loan documents and assume the security interest from the construction lender. If the project is being purchased for cash, the bank would release its lien and cancel the note.

Additionally, as the commercial project is leased, the lender should ensure that the bank's position is protected in the event that extended-term funding is not obtained. The bank may require tenants to enter into subordination, attornment, and nondisturbance agreements, which protect the bank's interests in the lease by providing for the assumption of the landlord's position by the bank in the event the borrower declares bankruptcy. Furthermore, to ensure that the bank has full knowledge of all provisions of the lease agreements, tenants should be required to sign an estoppel certification.

In some cases, the takeout lender may only pay off a portion of the construction loan because a conditional requirement for full funding has not been met, such as the project not attaining a certain level of occupancy. The construction lender would then have a second mortgage on the remaining balance of the construction loan. When the conditions of the takeout loan are met, the construction lender is repaid in full and the lien is released.

## Interest Reserves

A construction loan is generally an interest-only loan because of the fact that cash flow is not

available from most projects until they are completed. The borrower's interest expense is therefore borrowed from the construction lender as part of the construction loan for the purpose of "paying" the lender interest on the "portion" of the loan used for actual construction. The funds advanced to pay the interest are included as part of the typical monthly draw. As a result, the balance due to the lender increases with each draw by the full amount of construction costs, plus the interest that is borrowed.

The borrower's interest cost is determined by the amount of credit extended and the length of time needed to complete the project. This interest cost is referred to as an interest reserve. This period of time should be evaluated for reasonableness relative to the project being financed. In larger projects cash flow may be generated prior to the project's completion. In such cases, any income from the project should be applied to debt service before there is a draw on the interest reserve. The lender should closely monitor the lease-up of the project to ensure that the project's net income is being applied to debt service and not diverted to the borrower as a return of the developer's capital or for use in the developer's other projects.

## Loan Default

The inherent exposure in construction financing is that the full value of the collateral is not realized until the project is completed. In default situations the bank must consider the alternatives available to recover its advances. For uncompleted projects, the bank must decide whether it is more advantageous to complete the project or to sell on an "as is" basis. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Due to these factors, the construction lender may not be in the preferred position indicated by documents in the file. Therefore, the lender should take every precaution to minimize any third-party claim on the collateral. Because laws regarding the priority of certain liens may vary among states, the bank should take the necessary steps to ensure that its lien is recorded prior to the commencement of work or the delivery of materials and supplies.

## Signs of Problems

To detect signs of a borrower's financial problems, the bank should review the borrower's financial statements on a periodic (quarterly) basis, assessing the liquidity, debt level, and cash flow. The degree of information the financial statements provide the bank, insofar as understanding the borrower's financial condition is concerned, depends primarily on whether the borrower is a single-asset entity or a multi-asset entity.

The financial statements of a single-asset entity only reflect the project being constructed; therefore, they are of a more limited use than statements of multi-asset entities. Nevertheless, one issue that is of importance to financial statements of both entities relates to monitoring changes in accounts and trade payables. Monitoring these payables in a detailed manner helps the bank to determine if trade payables are paid late or if there are any unpaid bills. In the event of problems, a bank might choose to either contact the payables directly or request an additional credit check on the borrower. Another source of information indicating borrower problems is local publications that list lawsuits or judgments that have been filed or entered against the borrower. Additionally, the bank should also verify that the borrower is making its tax payments on time.

In a multi-asset entity, on the other hand, more potential problems could arise due to the greater number of assets (projects/properties) that make up the borrower. As a result, it is necessary to obtain detailed financial statements of each of the assets (projects/properties) and the consolidating financial statements, as well as the consolidated financial statements. This is important because each kind of statement can provide significant insight into problems that could adversely affect the borrower's overall financial condition.

Assessing the financial condition of the multi-asset entity includes evaluating the major sources of cash and determining whether cash flow is dependent on income generated from completed projects, the sale of real estate, or infusion of outside capital. Additionally, the bank should also review the borrower's account receivables for the appropriateness of intercompany transactions and to guard against diversion of funds.

Depending upon the structure of the loan, it may also be desirable to obtain a partner's/

guarantor's financial statements on a periodic basis. In such cases it is important to obtain detailed current and accurate financial statements that include cash flow information on a project-by-project basis.

Slow unit sales, or excessive inventory relative to sales, indicate the borrower may have difficulty repaying the loan. Although sometimes there are mitigating factors beyond the control of the borrower, such as delays in obtaining materials and supplies, adverse weather conditions, or unanticipated site work, the borrower may be unable to overcome these problems. Such delays usually increase project costs and could hamper the loan's repayment.

The construction lender should be aware of funds being misused—for example, rebuilding to meet specification changes not previously disclosed, starting a new project, or possibly paying subcontractors for work performed elsewhere. The practice of “front loading,” whereby a builder deliberately overstates the cost of the work to be completed in the early stages of construction, is not uncommon and, if not detected early on, will almost certainly result in insufficient loan funds with which to complete construction in the event of a default.

## Loan Workouts

Sound workout programs begin with a full disclosure of all relevant information based on a realistic evaluation of the borrower's ability to manage the business entity (business, technical, and financial capabilities), and the bank's ability to assist the borrower in developing and monitoring a feasible workout/repayment plan. Management should then decide on a course of action to resolve the problems with the terms of the workout in writing and formally agreed to by the borrower. If additional collateral is accepted or substituted, the bank should ensure that the necessary legal documents are filed to protect the bank's collateral position.

In those cases where the borrower is permitted to finish the project, additional extensions of credit for completing the project, due to cost overruns or an insufficient interest reserve, may represent the best alternative for a workout plan. At the same time, the bank should evaluate the cause of the problem(s), such as mismanagement, and determine whether it is in its best

interest to allow the borrower to complete the project.

## SUPERVISORY POLICY

As a result of competitive pressures, many banks in the early 1980s made construction loans on an open-end basis, wherein the borrower did not have a commitment for longer-term or takeout financing before construction was started. Although there was sufficient demand for commercial real estate space when this practice commenced, the supply of space began to exceed demand. One symptom of the excess supply was an increase in vacancy rates, which led to declining rental income caused by the ever greater need for rent concessions. The commensurate declining cash flow from income-producing properties, and the uncertainty regarding future income, reduced the market value of many properties to levels considered undesirable by permanent mortgage lenders. As a result of the subsequent void created by the permanent lenders, banks in the mid- and late 1980s began to extend medium-term loans with maturities for up to seven years (also referred to as mini-perms). These mini-perms were granted with the expectation by banks that as the excess supply of space declined, the return on investment would improve, and permanent lenders would return.

As these loans mature in the 1990s, borrowers may continue to find it difficult to obtain adequate sources of long-term credit. In some cases, banks may determine that the most desirable and prudent course is to roll over or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who presently may not be in a position to obtain long-term financing for the loan balance.

The act of refinancing or renewing loans to sound borrowers, including creditworthy commercial or residential real estate developers, generally should not be subject to supervisory criticism in the absence of well-defined weaknesses that jeopardize repayment of the loans. Refinancings or renewals should be structured in a manner that is consistent with sound banking, supervisory, and accounting practices, and that protects the bank and improves its prospects for collecting or recovering on the asset.

# Real Estate Construction Loans Examination Objectives

Effective date November 1993

## Section 2100.2

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1. To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.
2. To determine if bank officers are operating in conformance with the bank's established guidelines.
3. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
4. To determine compliance with applicable laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Real Estate Construction Loans

## Examination Procedures

Effective date November 1993

## Section 2100.3

1. Refer to the Real Estate Loan Examination Procedures section of this manual for examination procedures related to all types of real estate lending activity, and incorporate into this checklist those procedures applicable to the review of the real estate construction loans. The procedures in this checklist are unique to the review of a bank's construction lending activity.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal/external auditors.
3. Test real estate construction loans for compliance with policies, practices, procedures, and internal controls by performing the remaining examination procedures in this section. Also, obtain a listing of any deficiencies noted in the latest internal/external audit reviews and determine if appropriate corrections have been made.
4. Review management reports on the status of construction lending activity, economic developments in the market, and problem loan reports.
5. Evaluate the bank with respect to—
  - a. the adequacy of written policies and procedures relating to construction lending.
  - b. operating compliance with established bank policy.
  - c. favorable or adverse trends in construction lending activity.
  - d. the accuracy and completeness of the bank's records.
  - e. the adequacy of internal controls, including control of construction draws.
  - f. the adherence of lending staff to lending policies, procedures, and authority as well as the bank's adherence to the holding company's loan limits, if applicable.
  - g. compliance with laws, regulations, and Federal Reserve policy on construction lending activity, including supervisory loan-to-value (LTV) limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and prudent lending practices.
6. Select loans for examination, using an appropriate sampling technique drawn from judgmental (cut-off line) or statistical sampling. Analyze the performance of the loans selected for examination by transcribing the following kinds of information onto the real estate construction loan line cards, when applicable:
  - a. Collateral records and credit files, including the borrower's financial statements, review of related projects, credit report of the borrower and guarantors, appraisal or evaluation of collateral, feasibility studies, economic impact studies, and loan agreement and terms.
  - b. Loan modification or restructuring agreements to identify loans where interest or principal is not being collected according to the terms of the original loan. Examples include reduction of interest rate or principal payments, deferral of interest or principal payments, or renewal of a loan with accrued interest rolled into the principal.
  - c. The commitment agreement—a buy/sell contract or the tri-party agreement—from the extended-term or permanent lender for the takeout loan.
  - d. Cash-flow projections and any revisions to projections based on cost estimates from change orders.
  - e. Estimates of the time and cost to complete construction.
  - f. Inspection reports and evaluations of the cost to complete, construction deadlines, and quality of construction.
  - g. Construction draw schedules and audits for compliance with the schedules.
  - h. Documentation on payment of insurance and property taxes.
  - i. Terms of a completion or performance bond.
  - j. Past-due/nonaccrual-related information.
  - k. Loan-specific internal problem credit analyses information.
  - l. Loans to insiders and their interests.
  - m. Loans classified during the preceding examination.
7. In analyzing the selected construction loans, the examiner should consider the following procedures, taking appropriate action if necessary:

- a. Determine the primary source of repayment and evaluate its adequacy, including whether—
    - the permanent lender has the financial resources to meet its commitment.
    - the amount of the construction loan and its estimated completion date correspond to the amount and expiration date of the takeout commitment and/or completion bond.
    - the permanent lender and/or the bonding company have approved any modifications to the original agreement.
    - properties securing construction loans that are not supported by a takeout commitment will be marketable upon completion.
  - b. Analyze secondary support afforded by guarantors and partners.
  - c. Relate collateral values to outstanding debt by—

assessing the adequacy of the appraisal and evaluation.

    - ascertaining whether inspection reports support disbursements to date.
    - determining whether the amount of undisbursed loan funds is sufficient to complete the project.
    - establishing whether title records assure the primacy of the bank's liens.
    - determining if adequate hazard, builder's risks, and worker's compensation insurance is maintained.
  - d. Determine whether the loan's loan-to-value (LTV) ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.
  - e. Ascertain whether the loan complies with established bank policy.
  - f. Identify any deficiencies in the loan's documentation in both the credit files and the collateral records.
  - g. Identify whether the loan is to an officer, director, or shareholder of the bank or a correspondent bank and whether an officer, director, or shareholder of the bank is a guarantor on the loan.
  - h. Review the borrower's compliance with the provisions of the loan agreement, indicating whether the loan is in default or in past-due status.
  - i. Determine if there are any problems that may jeopardize the repayment of the construction loan.
  - j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank or from the repossession of the property.
8. In connection with the examination of other lending activity in the bank, the examiner should—
    - a. check the central liability file on the borrower(s) and determine whether the total construction lending activity exceeds the lending limit to a single borrower.
    - b. obtain information and related performance status on common borrowers and their interests from examiners assigned to other examination areas (such as non-real estate loans, leasing, overdrafts, and cash items) and determine the total indebtedness of the borrower to the bank. Additionally, one examiner should be assigned to review the borrower's overall borrowing relationship with the bank.
    - c. perform appropriate procedural steps as outlined in the Concentration of Credits section of this manual. Interim construction loans that do not have firm permanent takeout commitments are to be treated as concentrations of credit.
  9. Consult with the examiner responsible for the asset/liability management analysis portion of the examination to determine the appropriate maturity breakdown of construction loans needed for the analysis and prepare the necessary schedules.
  10. Summarize the findings of the construction loan portfolio review and address—
    - a. the scope of the examination.
    - b. the quality of the policies, procedures, and controls.
    - c. the general level of adherence to policies and procedures.
    - d. the competency of management.
    - e. the quality of the loan portfolio.
    - f. loans not supported by current and complete financial information.
    - g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, feasibility studies, the environmental impact study, takeout commitment, title policy, construction plans, inspection reports, change orders, proof of payment for

- insurance and taxes, deeds of trust, and mortgage notes.
- h. the adequacy of control over construction draws and advances.
- i. loans to officers, directors, shareholders, or their interests.
- j. causes of existing problems.
- k. delinquent loans and the aggregate amount of statutory bad debts. Refer to the manual section on classification of credits for a discussion on statutory bad debts or A Paper.
- l. concentrations of credits.
- m. classified loans.
- n. violations of laws, regulations, and Federal Reserve policy.
- o. action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the bank's response to such recommendations.

# Real Estate Construction Loans

## Internal Control Questionnaire

Effective date November 1993

Section 2100.4

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate construction loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES AND OBJECTIVES

- \*1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written construction lending policies that—
  - a. outline construction lending objectives regarding—
    - the aggregate limit for construction loans?
    - concentrations of credit in particular types of construction projects?
  - b. establish minimum standards for documentation?
  - c. define qualified collateral and minimum margin requirements?
  - d. define the minimum equity requirement for a project?
  - e. define loan-to-value (LTV) limits that are consistent with supervisory LTV limits?
  - f. require an appraisal or evaluation that complies with the Federal Reserve real estate appraisal regulation and guidelines?
  - g. delineate standards for takeout commitments?
  - h. indicate completion bonding requirements?
  - i. establish procedures for reviewing construction loan applications?
  - j. detail methods for disbursing loan proceeds?
  - k. detail project inspection requirements and progress reporting procedures?

- l. require agreements by borrowers for completion of improvements according to approved construction specifications, and cost and time limitations?
- 2. Are construction lending policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?

### REVIEWING LOAN APPLICATIONS

- 3. Does bank policy require a personal guarantee from the borrower on construction loans?
- 4. Does bank policy require personal completion guarantees by the property owner and/or the contractor?
- 5. Does the bank require a construction borrower to contribute equity to a proposed project in the form of money or real estate? If so, indicate which form of equity.
- 6. Does the project budget include the amount and source of the builder's and/or owner's equity contribution?
- 7. Does the bank require—
  - a. background information on the borrower's, contractor's, and major subcontractors' development and construction experience, as well as other projects currently under construction?
  - b. payment history information from suppliers and trade creditors on the aforementioned's previous projects?
  - c. credit reports?
  - d. detailed current and historical financial statements, including cash flow-related information?
- 8. Do the borrower's project cost estimates include—
  - a. land and construction costs?
  - b. off-site improvement expenses?
  - c. soft costs, such as organizational and administrative costs, and architectural, engineering, and legal fees?
  - d. interest, taxes, and insurance expenses?
- 9. Does the bank require an estimated cost breakdown for each stage of construction?



10. Does the bank require that cost estimates of more complicated projects be reviewed by qualified personnel: experienced in-house staff, an architect, construction engineer, or independent estimator?
11. Are commitment fees required on approved construction loans?

## CONSTRUCTION LOAN AGREEMENT

12. Is the construction loan agreement signed before an actual loan disbursement is made?
- \*13. Is the construction loan agreement reviewed by counsel and other experts to determine that improvement specifications conform to—
  - a. building codes?
  - b. subdivision regulations?
  - c. zoning and ordinances?
  - d. title and/or ground lease restrictions?
  - e. health and handicap access regulations?
  - f. known or projected environmental protection considerations?
  - g. specifications required under the National Flood Insurance Program?
  - h. provisions in tenant leases?
  - i. specifications approved by the permanent lender?
  - j. specifications required by the completion or performance bonding company and/or guarantors?
- \*14. Does the bank require all change orders to be approved in writing by the—
  - a. bank?
  - b. bank's counsel?
  - c. permanent lender?
  - d. architect or supervising engineer?
  - e. prime tenants bound by firm leases or letters of intent to lease?
  - f. completion bonding company?
15. Does the construction loan agreement set a date for project completion?
16. Does the construction loan agreement require that—
  - a. the contractor not start work until authorized to do so by the bank?
  - b. on-site inspections be permitted by the lending officer or an agent of the bank without prior notice?
  - c. disbursement of funds be made as work progresses, supported by documenta-

- tion that the subcontractors are receiving payment and that the appropriate liens are being released?
- d. the bank be allowed to withhold disbursements if work is not performed according to approved specifications?
- e. a percentage of the loan proceeds be retained pending satisfactory completion of the construction?
- f. the lender be allowed to assume prompt and complete control of the project in the event of default? If a commercial project, are the leases assignable to the bank?
- g. the contractor carry builder's risk and worker's compensation insurance? If so, has the bank been named as mortgagee or loss payee on the builder's risk policy?
- h. periodic increases in the project's value be reported to the builder's risk and title insurance companies?
17. In addition to the aforementioned points, does the construction loan agreement for residential tract construction loans require—
  - a. bank authorization for individual tract housing starts?
  - b. periodic sales reports be submitted to the bank?
  - c. periodic reports on tract houses occupied under a rental, lease, or purchase option agreement be submitted to the bank?
  - d. limitations on the number of speculative houses and the completion of one tract prior to beginning another?

## COLLATERAL

18. Are liens filed on non-real estate construction improvements, i.e., personal property that is movable from the project?
19. When entering into construction loans, does the bank, consistent with supervisory loan-to-value limits—
  - a. limit the loan amount to a reasonable percentage of the appraised value of the project when there is no prearranged permanent financing?
  - b. limit the loan amount to a percentage of the appraised value of the completed

- project when subject to the bank's own takeout commitment?
- c. limit the loan amount to the floor of a takeout commitment that is based upon achieving a certain level of rents or lease occupancy?
20. Are unsecured credit lines to contractors or developers, who are also being financed by secured construction loans, supervised by the construction loan department or the officer supervising the construction loan?
21. Does the bank have adequate procedures to determine whether construction appraisal or evaluation policies and procedures are consistently being followed in conformance with regulatory requirements, and that the appraisal or evaluation documentation supports the value indicated in the conclusions?
- e. compared to original cost estimates?
  - f. checked against previous disbursements?
  - g. made directly to subcontractors and suppliers?
  - h. supported by invoices describing the work performed and the materials furnished?
29. Does the bank obtain waivers of subcontractor's and mechanic's liens as work is completed and disbursements are made?
30. Does the bank obtain sworn and notarized releases of mechanic's liens from the general contractor at the time construction is completed and before final disbursement is made?
31. Does the bank periodically review undisbursed loan proceeds to determine their adequacy to complete the projects?
32. Are the borrower's undisbursed loan proceeds and contingency or escrow accounts independently verified at least monthly by someone other than the individuals responsible for loan disbursements?

## INSPECTION

22. Are inspection authorities noted in the—
- a. construction loan commitment?
  - b. construction loan agreement?
  - c. tri-party buy-and-sell agreement?
  - d. takeout commitment?
23. Are inspections conducted on an irregular basis?
24. Are inspection reports sufficiently detailed to support disbursements?
25. Are inspectors rotated from project to project?
26. Are spot checks made of the inspectors' work?
27. Do inspectors determine compliance with plans and specifications as well as the progress of the work? If so, are the inspectors competent to make the determination?

## DISBURSEMENTS

- \*28. Are disbursements—
- a. advanced on a prearranged disbursement plan?
  - b. made only after reviewing written inspection reports?
  - c. authorized in writing by the contractor, borrower, inspector, subcontractors, and/or lending officer?
  - d. reviewed by a bank employee who had no part in granting the loan?

## TAKEOUT COMMITMENT

33. Does counsel review takeout agreements for acceptability?
34. Does the bank obtain and review the permanent lender's financial statements to determine the adequacy of its financial resources to fulfill the takeout commitment?
35. Is a tri-party buy-and-sell agreement signed before the construction loan is closed?
36. Does the bank require takeout agreements to include a *force majeure*—an act of God clause—that provides for an automatic extension of the completion date in the event that construction delays occur for reasons beyond the builder's control?

## COMPLETION BONDING REQUIREMENTS

37. Does the bank require completion insurance for all construction loans?
38. Has the bank established minimum financial standards for borrowers who are not required to obtain completion bonding? Are these standards observed in all cases?

39. Does counsel review completion insurance bonds for acceptability?

## DOCUMENTATION

40. Does the bank require and maintain documentary evidence of—
- the contractor's payment of—
    - employee withholding taxes?
    - builder's risk insurance?
    - worker's compensation insurance?
    - public liability insurance?
    - completion insurance?
  - the property owner's payment of real estate taxes?
41. Does the bank require that documentation files include—
- loan applications?
  - financial statements for the—
    - borrower?
    - builder?
    - proposed prime tenant?
    - takeout lender?
    - guarantors/partners?
  - credit and trade checks on the—
    - borrower?
    - builder?
    - major subcontractor?
    - proposed tenants?
  - a copy of plans and specifications?
  - a copy of the building permit?
  - a survey of the property?
  - the construction loan agreement?
  - an appraisal or evaluation and feasibility study?
  - an up-to-date title search?
  - the mortgage?
  - ground leases?
  - assigned tenant leases or letters of intent to lease?
  - a copy of the takeout commitment?
  - a copy of the borrower's application to the takeout lender?
  - the tri-party buy-and-sell agreement?
  - inspection reports?
  - disbursement authorizations?
  - undisbursed loan proceeds and contingency or escrow account reconcilements?
  - insurance policies?
42. Does the bank employ standardized checklists to control documentation for individual files and perform audit reviews for adequacy?
43. Does the documentation file indicate all of the borrower's other loans and deposit account relationships with the bank and a summary of other construction projects being financed by other banks? Does the bank analyze the status of these projects and the potential effect on the borrower's financial position?
44. Does the bank use tickler files that—
- control scheduling of inspections and disbursements?
  - assure prompt administrative follow-up on items sent for—
    - recording?
    - attorney's opinion?
    - expert review?
45. Does the bank maintain tickler files that provide advance notice (such as 30 days' prior notice) to staff of the expiration dates for—
- the takeout commitment?
  - hazard insurance?
  - worker's compensation insurance?
  - public liability insurance?

## LOAN RECORDS

- \*46. Are the preparation, addition, and posting of subsidiary real estate construction loan records performed or adequately reviewed by persons who do not also—
- issue official checks or drafts?
  - handle cash?
  - reconcile subsidiary records to general ledger controls?
- \*47. Are the subsidiary real estate construction loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?
- \*48. Are loan statements, delinquent account collection requests, and past-due notices reconciled to the real estate construction loan subsidiary records? Are the reconciliations handled by a person who does not also handle cash?
49. Are inquiries about construction loan balances received and investigated by persons who do not also handle cash?
- \*50. Are documents supporting recorded credit

- adjustments subsequently checked or tested by persons who do not also handle cash?
51. Is a delinquent accounts report generated daily?
52. Are loans in excess of supervisory LTV limits identified in the bank's records and are the aggregate amounts of such loans reported at least quarterly to the board of directors?
53. Does the bank maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
54. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

## LOAN INTEREST AND COMMITMENT FEES

- \*55. Are the preparation and posting of loan interest and fee records performed or ade-

quately reviewed by persons who do not also—

- a. issue official checks or drafts?  
b. handle cash?
56. Are any independent interest and fee computations made and compared or adequately tested to loan interest by persons who do not also—
- a. issue official checks or drafts?  
b. handle cash?

## CONCLUSION

57. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
58. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

### INTRODUCTION

Floor-plan lending is a form of dealer-inventory financing in which each loan advance, which may be as much as 100 percent of the dealer's invoiced cost, is collateralized by a specific piece of inventory. As each unit of inventory is sold by the dealer, the loan advance against that unit of inventory is repaid. Floor-planned items typically have broad consumer demand. Items commonly subject to floor-plan debt are automobiles, large home appliances, furniture, televisions and stereo equipment, boats, mobile homes, and other types of merchandise usually sold under a sales-finance contract. Floor-plan financing involves all the basic risks inherent in any form of inventory financing. However, because of the high loan-to-value ratios typical of floor-plan financing, the exposure to loss is generally greater than in other types of inventory financing.

### COLLATERAL

As with all inventory financing, collateral value is of prime importance. Control over collateral value requires the bank to determine the value at the time the loan is placed on the books, to periodically inspect the collateral to determine its condition and location, and to determine whether any curtailment payments<sup>1</sup> are needed to keep the loan balance in line with depreciating collateral values. As a general rule, curtailment payments are not required for new automobile models until the model year is approximately one-half over. Periodic curtailment payments are then expected to commence at some predetermined percentage of the amount financed.

### Collateral Inspections

The examiner should determine whether the bank is inspecting the collateral frequently and

thoroughly enough to ensure compliance with the floor-plan agreement. Inspections should be conducted on a surprise basis. Floor-plan inspection reports should be reviewed and retained by the bank. Where practical, inspection duties should be rotated among the bank's staff. Banks should verify the floor-planned inventory by comparing serial numbers with manufacturers' certificates of origin or titles and to the bank's records, and the inspection reports should reflect whether the floor-planned inventory is available for sale. Any missing inventory or other exceptions revealed by the inspection, and the dealer's explanation, should be noted in the inspection report.

### SECURITY INTEREST

In most banks, the security interest to floor-planned inventory is evidenced by a trust receipt.<sup>2</sup> Generally, trust receipts are created by two methods. First, the bank may enter into a drafting agreement with the manufacturer, which is similar to a letter of credit. In this situation, the bank agrees to pay documentary drafts covering shipments of merchandise to the dealer. The drafts are payable at the time the merchandise is received by the dealer or, if the manufacturer permits, after a grace period, which allows the dealer to prepare the inventory for sale. The drafting agreement usually limits the number of units, the per-unit cost, and the aggregate cost that can be shipped at one time. Drafting agreements are frequently used in conjunction with repurchase agreements when the manufacturer agrees to repurchase inventory that remains unsold after a specified period of time. The inventory and related title documents remain with the dealer until they are sold and are evidenced by a trust receipt. Banks should physically inspect all the documents during the floor-plan inspection to prevent dual financing.

Second, trust receipts are also created when merchandise is shipped under an invoice sys-

1. Curtailment payments are payments made by the dealer to the floor-plan lender when an item of floor-planned inventory is not sold during the anticipated time frame. The implicit assumption is that if the floor-planned inventory is not sold as anticipated, the inventory value depreciates over time. Unless a curtailment payment is made, the bank's loan-to-value ratio would increase and place the bank in a riskier position than desired.

2. A trust receipt is a document issued to the floor-plan lender by the dealer receiving the floor-plan financing. The trust receipt provides evidence that the dealer possesses the floor-planned inventory. It establishes the bank's rights to the inventory collateral and its proceeds or refers to other documents that set forth the rights of the bank.

tem. The dealer receives the inventory accompanied by invoices and titles, where appropriate. The dealer presents the documents to the bank and the bank pays the invoice, attaching duplicates of the documents to a trust receipt that is signed by the borrower. Depending on the type of inventory and the dealer, the title may remain in the bank or be released. For example, used car inventories are usually financed with trust receipts listing each item of the inventory and its loan value.

The method of perfecting a security interest varies from state to state, and there can be divergences from the Uniform Commercial Code. The examiner should determine that the security interest has been properly perfected. For a detailed discussion of the UCC requirements regarding secured transactions, refer to section 2080.1, "Commercial and Industrial Loans."

## BANK/DEALER RELATIONSHIP

Two important facets of the bank's relationship with a dealer are (1) the quality of the paper generated and (2) the deposit account maintained. The income derived from a floor-plan loan may not be sufficient to justify the credit risk. However, additional income derived from quality loans to purchasers of the dealer's inventory may justify the credit risk. If the bank is not receiving an adequate portion of loans generated by the dealer or if the paper is of inferior quality, the relationship is of questionable value to the bank. The dealer's deposit relationship represents both a compensating balance and a tool by which the loan officer can monitor customer activity. A review of the flow of funds into and out of the dealer's account may suggest that inventory has been sold without debt reduction, that the dealer is incurring abnormal expenses, or that unreported diversification, expansion, or other financial activity has occurred that might warrant a reconsideration of the credit arrangement. Token or overdrawn balances should also trigger increased attention to the value of the relationship.

## DEALER FINANCIAL ANALYSIS

Many dealers have minimal liquidity and capital relative to total debt. Therefore, the bank should closely and frequently review the dealer's finan-

cial information. Annual and interim financial statements are necessary to monitor the dealer's condition. Interim financial statements are often in the form of monthly financial reports to the dealer's franchiser. In analyzing the data, the bank should review the number of units sold and the profitability of those sales, as well as compare the number of units sold with the number financed to determine that inventory levels are reasonable.

Inventory will invariably be a dealer's primary asset, and its acquisition will normally create the dealer's major liability. The dealer's financial statement should show an inventory figure at least equal to the related flooring liability. Unless the difference is represented by short-term sales receivables, including contracts in transit, a floor-plan liability that is greater than the amount of inventory is an indication that the dealer has sold inventory and has not made the appropriate loan payment. To assess credit quality, it is essential that the examiner closely evaluate the level of floor-plan debt relative to inventory.

## IDENTIFYING PROBLEMS

Missing inventory, reportedly sold and unpaid, should be verified to related contracts-in-process. Time to collect on contracts-in-process should be reasonable and conform to the floor-plan agreement. Floor-planned inventory sold and *not* in the process of payment is termed "sold out of trust" and represents a breach of trust by the dealer—and a significant exposure to the bank.

During floor-plan inspections, recurring out-of-trust positions that are not cleared in a reasonable time frame (three to five days) should be a red flag. If a bank discovers that a dealer is deliberately withholding funds or diverting funds received from the sale of pledged inventory, bank officials should meet with the borrower to discuss this situation and, if appropriate, consider terminating the lending relationship. Banks should avoid complicated situations in which they finance only part of the dealer's floor-plan debt that originates from one particular manufacturer or distributor. Other warning signs banks should be aware of include interest or curtailment payment delinquencies, extended maturities beyond reasonable expectations, slow-moving inventory, and the absence of interim financial statements.

## LOAN POLICY

The bank's loan policy should establish sound standards to control the credit and operational risks associated with floor-plan lending. At a minimum, the policy should address the need

for detailed tri-party (manufacturer, dealer, and banker) floor-plan agreements, loan-to-value requirements, the percentage amount and timing of curtailment payments, inspection standards, and the frequency for obtaining and evaluating financial statements.

# Floor-Plan Loans

## Examination Objectives

Effective date May 1996

## Section 2110.2

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1. To determine if policies, practices, procedures, and internal controls for floor-plan loans are adequate.
2. To determine if bank officers are conforming to established guidelines.
3. To evaluate the quality of the loan portfolio and the sufficiency of its collateral.
4. To determine the scope and effectiveness of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.



# Floor Plan Loans

## Examination Procedures

Effective date March 1984

## Section 2110.3

1. If selected for implementation, complete or update the Floor Plan Loans section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and of the work performed by internal/external auditors determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if corrections have been accomplished.
4. Request the bank to supply:
  - a. Schedule of curtailment requirements for each dealer.
  - b. Schedule of approved floor plan lines for each dealer including outstanding balances.
  - c. Delinquent curtailment billing report.
  - d. Drafting agreements and amount of outstanding drafts.
  - e. Delinquent interest billings, date billed and amount of past due interest.
5. Obtain a trial balance of all floor plan accounts and:
  - a. Agree balances to department controls and general ledger.
  - b. Review reconciling items for reasonableness.
6. Using an appropriate technique, select borrowers for examination.
7. Using the trial balance, transcribe the following information for each borrower selected onto the credit line cards:
  - a. Total outstanding liability.
  - b. Number of items.
  - c. Status of any outstanding interest or curtailment billings.
  - d. Amount of approved floor plan line.
8. Obtain liability and other information on common borrowers from examiners assigned to overdrafts, lease financing and other loan areas and together decide who will review the borrowing relationship.
9. Obtain from the bank or appropriate examiner the following schedules, if applicable to this area:
  - a. Past-due loans.
  - b. Loans in a nonaccrual status.
  - c. Loans on which interest is not being collected in accordance with the terms of the loan. Particular attention should be given to loans which have been renewed with interest being rolled into principal.
  - d. Loans whose terms have been modified by a reduction on interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms.
  - e. Loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation or asset swap, since the previous examination.
  - f. Loans acquired from another lending institution as a result of a purchase, participation or asset swap, since the previous examination.
  - g. Loan commitments and other contingent liabilities.
  - h. Extensions of credit to employees, officers, directors, principal shareholders and their interests, specifying which officers are considered executive officers.
  - i. Extensions of credit to executive officers, directors, principal shareholders and their interests, of correspondent banks.
  - j. A list of correspondent banks.
  - k. Miscellaneous loan debit and credit suspense accounts.
  - l. Loans considered "problem loans" by management.
  - m. Specific guidelines in the lending policy.
  - n. Each officer's current lending authority.
  - o. Current interest rate structure.
  - p. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee.
  - q. Reports furnished to the loan and discount committee or any similar committee.
  - r. Reports furnished to the board of directors.
  - s. Loans classified during the previous examination.
10. Review the information received and perform the following for:
  - a. Loans transferred, either in whole or in part, to or from another lending institu-

tion as a result of a participation, sale/purchase, or asset swap:

- Participations only:
    - Test participation certificates and records and determine that the parties share in the risks and contractual payments on pro rata basis.
    - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
  - Procedures pertaining to *all* transfers:
    - Investigate any situations where loans were transferred immediately prior to the date of examination to determine if any were transferred to avoid possible criticism during the examination.
    - Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
    - Determine that low-quality loans transferred to or from the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium).
    - Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
    - If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
      - Name of originating institution.
      - Name of receiving institution.
      - Type of transfer (i.e., participation, purchase/sale, swap).
      - Date of transfer.
      - Total number of loans transferred.
      - Total dollar amount of loans transferred.
      - Status of the loans when transferred (e.g., nonperforming, classified, etc.).
      - Any other information that would be helpful to the other regulator.
  - b. For miscellaneous loan debit and credit suspense accounts:
    - Discuss with management any large or old items.
    - Perform additional procedures as deemed appropriate.
  - c. For loans classified during the previous examination, determine disposition of loans so classified by reviewing:
    - Current balances and payment status, or
    - Date loan was repaid and sources of payment.
    - Investigate any situations where all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale or swap with another lending institution.
    - If repayment was a result of a participation, sale or swap, refer to step 10a of this section for the appropriate examination procedures.
  - d. For loan commitments and other contingent liabilities, analyze if:
    - The borrower has been advised of the contingent liability.
    - The combined amounts of the current loan balance and the commitment or contingent liability exceeds the cutoff.
  - e. Select loans which require in-depth review based on information derived from the above schedules.
11. Consult with the examiner responsible for the Asset/Liability Management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. Refer to the Instructions for the Report of Examination section of this manual for considerations to be taken into account

- when compiling maturity information for the GAP analysis.
12. For those loans selected in step 6 above and for any other loans selected while performing the above steps:
    - a. Transcribe the following information from the bank's collateral record onto the credit line card.
      - A list of items floored, including date of entry, description of property, amount advanced and curtailment, if any. (Similar items and model year should be shown in aggregate and entry dates shown as a range, except on stale or not properly curtailed items.)
      - A summary of the wholesale agreement between the bank and the dealer.
      - A summary of the agreement between the manufacturer and the bank.
      - A summary of any repurchase agreement.
      - Evidence that security interest has been perfected.
      - Details of any guarantees that may be held.
      - Details of any other collateral held.
    - b. Review the two most recent floor plan inspection reports and determine:
      - If any items were sold out of trust.
      - That where trust receipts are used, all title documents were physically inspected.
      - That appropriate follow-up was made on all missing items.
  13. Determine compliance with laws and regulations pertaining to floor plan loans by performing the following steps for:
    - a. *Lending Limits*:
      - Determine the bank's lending limits as prescribed by state law.
      - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    - b. *18 USC 215—Commission or Gift for Procuring Loan*:
      - While examining the floor plan loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
      - Investigate any such suspected situation.
    - c. *12 USC 1972—Tie-in Provisions*:
      - While reviewing credit and collateral files (especially loan agreements) determine whether any extension of credit is conditioned upon:
        - Obtaining or providing an additional credit, property, or service to or from the bank or its holding company, other than a loan, discount, deposit or trust service.
        - The customer not obtaining a credit, property or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to assure the soundness of the credit.
    - d. *Insider Lending Activities*. The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):
      1. *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, Principal Shareholders, and Their Interests*:
        - While reviewing information relating to insiders received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps):
          - Test the accuracy and completeness of information about floor plan loans by comparing it to the trial balance or loans sampled.
          - Review credit files on insider loans to determine that required information is available.
          - Determine that loans to insiders do not contain terms more favorable than those afforded other borrowers.
          - Determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features.
          - Determine that loans to insiders, as defined by the various sections of Regulation O, do

- not exceed the lending limits imposed by those sections.
  - If prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained.
  - Determine compliance with the various reporting requirements for insider loans.
  - Determine that the bank has made provisions to comply with the public disclosure requirements for insider loans.
  - Determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years.
2. *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2))—Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks:*
- Obtain from or request the examiners reviewing "Due from Banks" and "Deposit Accounts" to verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
  - Determine that loans to insiders of correspondent banks are not made on preferential terms, and that no conflict of interest appears to exist.
14. Perform appropriate procedural steps in "Concentration of Credits" section.
  15. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    - a. Delinquent loans, including breakout of "A" paper.
    - b. Extensions of credit to employees, officers, directors and/or their interests.
    - c. Loans on which collateral documentation is deficient.
    - d. Transfers of low-quality loans to or from another lending institution.
    - e. The adequacy of written policies relating to floor plan loans.
    - f. The manner in which bank officers are conforming with established policy.
    - g. Schedules applicable to the department that were discovered to be incorrect or incomplete.
    - h. The performance of departmental management.
    - i. Internal control deficiencies or exceptions.
    - j. Recommended corrective action when policies, practices or procedures are deficient.
    - k. Other matters of significance.
  16. Update the workpapers with any information that will facilitate future examinations.

# Floor Plan Loans

## Internal Control Questionnaire

Effective date March 1984

## Section 2110.4

Review the bank's internal controls, policies, practices and procedures for making and servicing floor plan loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written floor plan loan policies that:
  - a. Establish procedures for reviewing floor plan applications?
  - b. Define qualified borrowers, overall limits, and types of merchandise to be floor planned?
  - c. Establish minimum standards for documentation?
  - d. Establish curtailment amounts and time limits?
2. Are floor plan loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary floor plan loan records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
4. Are the subsidiary floor plan loan records reconciled daily with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?
- \*5. Are delinquent account collection requests and past-due notices checked to the trial balances used in reconciling floor plan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?
- \*6. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

- \*7. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?
8. Is a daily record maintained summarizing note transaction details, i.e., loans made, payments received and interest collected, to support applicable general ledger account entries?
9. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
10. Is an overdue account report generated frequently (if so, state frequency \_\_\_\_\_)?

### LOAN INTEREST

- \*11. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts singly?
  - b. Handle cash?
12. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
  - a. Issue official checks or drafts singly?
  - b. Handle cash?

### COLLATERAL

13. Are floor plan checks, physical inventories, conducted at least monthly and on a surprise basis (if so, state frequency \_\_\_\_\_)?
14. Are more frequent floor plan checks required if the dealer is experiencing financial difficulties?
15. Are individuals performing floor plan checks rotated?
16. Are floor plan inspector(s) required to determine or verify the following and indicate their findings on the floor plan check sheet:
  - a. Serial number of item?
  - b. Odometer reading of vehicles?
  - c. Condition of item?

- d. Location of item, if other than normal place of business?
- e. Existence of any fire or theft hazards?
17. Does the floor plan inspector include on the check sheet:
  - a. Date inspection was performed?
  - b. Date any item located elsewhere was checked?
  - c. His or her signature?
  - d. Summary of his or her report, if appropriate?
18. Are all demonstrators checked?
19. Are floor plan reports reviewed by an officer?
20. Are follow-up inspections made of items not seen during the regular inspection?
21. Are items reported by the dealer as being sold, required to be paid off immediately?
22. Does the floor plan inspector determine the date that item(s) reported as sold were sold from that on the dealer's copy of the sales agreement?
23. Are dealer sales patterns reviewed to determine that the number of units reported sold at the time of floor plan inspection is not excessive and does not indicate a float?
24. Are payments-in-process reported by the dealer during floor plan inspection verified by bank personnel?
25. When a dealer trade or "swap" occurs, does the bank:
  - a. Obtain the manufacturer's invoice from the selling dealer on the new unit acquired?
  - b. Obtain the invoice from the borrowing dealer for the new unit?
  - c. Have a trust receipt executed on the new unit?
26. Does the bank have a procedure to check all indirect paper received from a dealer against the trust receipts of items floored for that dealer to determine that there is no duplication of loans against the same security?
27. Does the bank have floor plan property damage insurance or require that the dealer maintain such coverage with the bank named as loss payee?
28. Is the insurance coverage periodically reviewed for adequacy?
29. Are all trust receipts required to be supported by invoices or other evidence that title to the security is vested in the bank?
30. Are trust receipts required to include:
  - a. Description of each item?
  - b. Serial number of each item?
  - c. Loan amount for each item?
  - d. Interest rate?
  - e. Date?
  - f. Authorized signature of dealer or person holding power-of-attorney to execute the trust receipt?
31. If the bank and dealer permit a bank employee to execute trust receipts using the dealer's power-of-attorney:
  - a. Are proper documents on file granting the power-of-attorney?
  - b. Does the bank maintain a numbered register for trust receipt notes?
  - c. Are trust receipt notes under dual control?

## OTHER

32. Are all floor plan loans granted under an established line?
33. Are line approvals structured to permit the bank to cancel or suspend shipments of unwanted merchandise?
34. Are dealer floor plan line limits strictly adhered to?
35. Is a trial balance of each dealer's trust receipts/security agreements prepared at least monthly?
36. Are dealer trial balances reconciled to department and general ledger controls?
37. Are floor plan interest charges systematically computed and regularly billed?
38. Are notices of past due interest payments sent promptly?
39. Are all interest, curtailment and unit pay off payments from dealers posted promptly?
40. Are disbursements for floor plan loans on new units made only against the original copy of the manufacturer's invoices?
41. Are the original invoices retained in the bank's files?
42. Are loan proceeds on new units paid directly to the manufacturer rather than to the dealer?
43. Are accounting records established so that the bank has records of all floored items with adequate individual identification?
44. Are limits on loan advance versus invoice price (current wholesale value, if used) clearly established?
45. Are wholesale values determined independently of dealer appraisals?

46. Are wholesale values that are assigned by floor plan department personnel periodically reviewed by someone independent of the department?
  47. Is amount of loan advance prohibited from exceeding 100 percent of the invoice price of a new item or of the wholesale value of a used item?
  48. Has a curtailment policy been established and is it being followed?
  49. Does the policy provide proper incentives to the dealer to turn over inventory on a timely basis?
  50. Is the loan written so that the floored items never depreciate faster than the loan balance is reduced?
  51. If a manufacturer of floored items has entered into a repurchase agreement, are curtailments structured to keep the loan balance in line with any declining repurchase amount?
  52. Are records maintained on curtailment billings so that delinquency is easily determinable?
  53. Are notices of past due curtailment payments sent promptly?
  54. If assignment of rebates has been made, have procedures been established to ensure that factory rebate checks payable at the end of the model year are promptly forwarded to the bank?
  55. If demonstrators are floored, are they subject to separate curtailment requirements which keep the loan balance in line with their liquidation value?
  56. Are floor plan agreements required for all dealers?
  57. Must agreements be accompanied by borrowing resolutions?
  58. Is a written agreement between the manufacturer and the bank required on any flooring line which includes drafting arrangements with the manufacturer?
  59. Do such agreements with the manufacturer stipulate under what conditions the bank will accept items to be floored?
  60. Are checks made periodically to determine that only those individuals granted power-of-attorney are signing the trust receipts?
  61. Are dealers required to submit financial and operating statements on a continuing basis?
  62. Are all dealers who prepare internal financial and operating statements more frequently than annually required to submit copies of those statements to the bank?
  63. Are all financial statements received from dealers reviewed promptly?
  64. Do financial statement reviews include a determination that floor plan loans, deposit accounts and other information agree with the bank's records?
  65. Are periodic reviews made of deposit accounts to detect any possible out-of-trust sales?
  66. Are periodic reviews made of the retail paper being generated to determine if the bank is receiving an adequate portion?
- ## CONCLUSION
67. Does the foregoing information constitute an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
  68. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

### INTRODUCTION

Leasing is a recognized form of financing for fixed assets that provides a lessee (the customer) the right to use depreciable assets without tying up working capital. Leasing frequently offers the lessee greater flexibility than traditional bank term-loan financing. Leasing also provides the lessor (the owner of the asset) with a generally higher rate of return than lending, but this is in exchange for assuming greater risk or investing more resources in marketing and deal-structuring. The higher risk inherent in a typical lease transaction is due to the higher advance to collateral value, a longer payment period, and, in some cases, the lessor's dependence on the sale of the leased property to recover a portion of the initial investment. In most instances, some or all of the higher rate of return for the lessor is derived from the tax benefits of equipment ownership.

While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management, and projections of future operations. Additional considerations are the type of property being leased and its marketability in the event of default or termination of the lease. However, these latter considerations do not radically alter how an examiner evaluates collateral for a lease. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Leases are generally structured so that the bank recovers the full cost of the equipment plus an interest factor over the course of the lease term. Sale of the leased property/collateral remains a secondary source of repayment and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance.

In general, leasing activities of state member banks are governed by federal tax law and, in some instances, applicable state law. The leasing of personal or real property or acting as agent, broker, or advisor in leasing such property is considered a "closely related nonbanking activity" and is therefore permitted under section 225.25(b)(5) of Regulation Y by a bank holding company or subsidiary thereof, in accordance with certain requirements. While not specifically applicable to banks, these criteria

provide useful guidelines for reviewing the appropriateness and prudence of bank leasing activities. Any substantial departure from these criteria must be judged in light of safety-and-soundness implications. The requirements for bank holding companies are as follows:

- The leased property must have been acquired by the financial institution specifically for the lease involved or for an earlier lease. This requirement prevents lessors from stockpiling or maintaining an inventory of property, thereby reducing the possibility of loss if the lessor is unable to lease the property.
- The lease transaction must be the "functional equivalent of an extension of credit" to the lessee of the property, with the lease written on a "full-payout" basis. The rentals to be received, estimated tax benefits (from accelerated depreciation), and estimated proceeds from the ultimate disposition of the property (limited to 25 percent of acquisition cost<sup>1</sup>) must be sufficient for the lessor to recover the full investment in the property, plus the estimated cost of financing the property during the lease term. However, the lease term required to derive full payout may not be longer than 40 years. For personal property leases of less than seven years duration, full payout may also be derived up to a maximum of 60 percent of acquisition cost from an unconditional guarantee of the lease payments by a lessee, an independent third party, or a manufacturer.
- The lease contract must be written on a "nonoperating" basis. For example, for purposes of the leasing of automobiles, the lessor (financial institution) may not be responsible for the operation, service, or maintenance of the property or be liable for payment of related insurance and taxes. Furthermore, the lessor may not provide parts or services or purchase insurance for the lessee, as these activities are considered to be more typical of merchandising than banking and, therefore, are not permitted.

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1. The estimated residual value of the property at the expiration of the initial term of the lease should not exceed 25 percent of the acquisition cost of the property to the lessor. There are exceptions to the 25 percent restriction under section 225.25(b)(5)(ii) of Regulation Y for certain "higher-residual-value leasing" of tangible personal property.



- Any property held by the lessor resulting from terminated leases must be liquidated or released within two years from the date of termination or default on the lease. For bank holding companies, the Board may, upon request, extend this two-year period based on certain situations outlined under section 225.22(c)(1) of Regulation Y.
- The lessor may not hold an interest in any property acquired for lease for a period exceeding 50 years. An exception to the full-payout criterion is made in the case of leases to certain government entities that are prohibited from entering into leases for periods exceeding one year. Property may be leased to these entities if the lessor can reasonably anticipate that the lease will be continually renewed until the investment in and cost of financing the property have been fully recovered. Any substantial departure from these criteria must be judged in light of safety-and-soundness implications.

Examiners should ensure that the bank’s policies and procedures appropriately govern its direct-lease-financing activities and that bank management adheres to established policies and procedures. Examiners should also ensure that the bank’s audit and loan review functions adequately encompass the leasing activity.

ACCOUNTING FOR LEASES

Since leasing activity became prominent within the last few decades, lessors have employed a number of different methods to account for their investments in leases. Financial Accounting Standards Board (FASB) Statement No. 13, “Accounting for Leases,” effective January 1, 1977, was intended to bring uniformity to lease accounting.<sup>2</sup> When a bank or bank holding company enters into a lease, it is generally structured as a direct financing lease and reported as such on the institution’s accounting records. A direct financing lease is a type of capital lease<sup>3</sup> that transfers substantially all the benefits

2. Other Financial Accounting Standards Board releases dealing with leasing are FASB Statements 22, 23, 27, 28, 29, 76, 77, 91, 94, 98, and 109; FASB Interpretations 19, 21, 23, 24, 26, and 27; and FASB Technical Bulletins 79-10, 79-12, 79-13, 79-14, 79-15, 79-16, 85-3, 86-2, and 88-1.

3. FASB Statement No. 13, paragraph 7, outlines in detail certain criteria that a lease must meet for it to be classified as a capital lease. (See also the call report instructions.)

and risks inherent in the ownership of the leased property to the lessee. In addition, collection of the minimum lease payments must be reasonably predictable, and no important uncertainties may exist regarding costs to be incurred by the lessor under the terms of the lease. Although minor variations in accounting methods are still found, most investment-in-leases accounts will be equal to—

- the sum of the minimum lease payments to be received from the lessee plus,
- the unguaranteed residual value (estimated fair market value) of the property at the end of the lease term reduced by,
- the amount of unearned and deferred income to be recognized over the life of the lease.

For the purpose of illustration, assume that property costing \$120,000 is leased for a period of 96 months at \$1,605 per month, and the estimated residual value (ERV) of the property is \$24,000. In this example, income is recognized monthly according to the sum-of-the-months’-digits method. The investment in this lease is calculated below, followed by an explanation of each component of the net investment.

Cost	\$120,000
Unearned income	34,080
Rentals receivable (96 × \$1,605)	154,080
Est. residual value	24,000
Gross investment	178,080
Less:	
Unearned income	34,080
Unearned income (ERV)	24,000
Net investment	120,000

Rentals Receivable

This account is established in the amount of total rental payments to be received from the lessee. The amount by which the rentals receivable (\$154,080) exceeds the cost of the property (\$120,000) is the functional equivalent of interest and represents a portion of the income to be recognized over the life of the lease. In the example below, the cost of the property is temporarily charged to a fixed-asset account, then transferred to rentals receivable.

Fixed assets	\$120,000	
Cash		120,000
To record purchase or property for lease		
Rentals receivable	154,080	
Fixed assets		120,000
Unearned income		34,080
To record amount due from lessee		

Throughout the lease term, the rentals-receivable account is periodically reduced by the full amount of each rental payment received.

Cash	\$1,605	
Rentals receivable		1,605
To record receipt of monthly payment		

recorded residual value, the difference will be recognized as either a gain or loss, whichever is appropriate.

Est. residual value	\$24,000	
Unearned income		24,000
To record ERV of leased property		
Cash	26,000	
Est. residual value		24,000
Gain on sale		2,000
To record sale of property		

Any portion of the ERV guaranteed by a party unrelated to the lessor would be deducted from the ERV account and added to rentals receivable.

## Unearned Income

### Estimated Residual Value

The estimated residual value represents the proceeds the lessor expects to realize at the end of the lease term from the sale or re-leasing of the property. Exactly as its title states, this account represents only an estimate of future value and does not represent current market value or depreciated book value. The residual value at the end of the lease term is considered to be income, and the corresponding credit for this asset account is posted to unearned income.

The balance of the ERV account does not normally change significantly during the lease term. The unguaranteed residual value should be reviewed at least annually to determine whether a decline, other than a temporary one, has occurred in its estimated value. If a decline is not temporary, the accounting for the lease transaction should be revised using the new estimate, and the resulting loss should be recognized in the period that the change is made. Upward adjustments or increases in the residual value are not recognized.

After the end of the term, the residual value account is eliminated from the books upon sale, re-lease, or other disposition of the property. If the amount of proceeds received differs from the

This liability account has a credit balance and is netted against the total of rentals receivable and the ERV for balance-sheet presentation. Its component parts are the “interest” income equal to the excess of rentals receivable over the cost of the property and the income to be realized from disposition of the property at the end of the lease term. Each of these components is recognized as income throughout the life of the lease by periodic transfers to earned income. Unearned income is amortized to income over the lease term to produce a constant periodic rate of return on the net investment in the lease. Any other method, such as the sum-of-the-months'-digits method, may be used if the results obtained are not materially different from those that would result from the interest method described in the preceding sentence and if the resulting impact does not overstate income during the current period. Loan-origination fees and initial direct costs, such as commissions and fees that are incurred by the lessor in negotiating and consummating the lease, are offset against each other, and the resulting net amount is deferred and recognized over the lease term. The practice of recognizing a portion of the unearned income at the inception of the lease to offset initial direct costs is no longer acceptable.

Depreciation

For certain leases, the lessor is entitled to claim depreciation for tax purposes. However, for financial statement purposes, no depreciation for leased property will appear on the income statement and no accumulated depreciation will appear on the balance sheet. If the lessor is entitled to the benefits of depreciation, then, for tax purposes only, depreciation will be calculated and will reduce the lessor's tax liability.

The lessor's entitlement to depreciation tax benefits is a function of the type of lease arrangement negotiated. When the lessor retains title to the asset and owns the asset at the expiration of the lease, the lessor may take depreciation into account for tax purposes. These characteristics are typical of a "true," "net," or "capital" lease, terms often used interchangeably in the industry. In a "financing" lease, the lessee rather than the lessor acquires title to the property at the expiration of the lease and is entitled to depreciation tax benefits. Accordingly, the lessor will charge the lessee a higher periodic lease payment (for a higher "rate of return") to offset its loss of depreciation tax benefits.

Balance-Sheet Presentation

Lease receivables are to be reported on the balance sheet as the single amount "net investment" (see below). If the lessor has established an allowance for possible lease losses, this amount is included in the total allowance for loan and lease losses and represents a deduction from the net investment. Footnotes to the balance sheet should disclose the components of the net investment, as follows:

Rentals receivable	\$154,080
Est. residual value	<u>24,000</u>
Gross investment	178,080
Less:	
Unearned income	<u>58,080</u>
Net investment	\$120,000

For call report purposes, lease financing receivables are reported net of unearned income as part of an institution's total loans.

Classification

If it is deemed appropriate to classify a lease, the amount at which the lease would be classified is the net investment. For example, assume that 94 of the 96 payments have been received on the above lease, that income has been recognized monthly according to the sum-of-the-months'-digits method, and that the lease is now considered a loss. Its balance on the books is \$27,173, as follows:

Rentals receivable	\$ 3,210
Est. residual value	<u>24,000</u>
Gross investment	27,210
Less:	
Unearned income	22
Unearned income (ERV)	<u>15</u>
Net investment	27,173

Classification of the \$27,173 balance of this lease involves classifying \$3,188 of the unrecovered portion of the cost of the property (\$3,210 less \$22 unearned income) plus \$23,985 of income that has already been recognized in anticipation of receiving the ERV (\$24,000 less \$15 not yet recognized). In short, the calculation is  $\$3,188 + \$23,985 = \$27,173$ .

Charging off the ERV included in the net investment treats the lease as if the underlying property has no value and, in effect, reverses the unearned income that has been recognized in anticipation of selling the leased property at its recorded ERV. Accordingly, if the property does have value, the \$27,173 classified should be reduced by the net amount that the lessor could realize by selling the property.

Delinquency

It is appropriate for the examination report to state the percentage of delinquency in the lease portfolio. The percentage is calculated by dividing the aggregate rentals receivable on delinquent leases (less the "interest" components of their unearned income accounts) by the total of rentals receivable on all leases (less the "interest" components of their unearned income accounts). ERVs would not be included in the

delinquent amounts since they do not represent obligations of the lessees.

If the lease obligation in the previously described classification example was the only delinquent obligation in a portfolio of leases with component accounts as shown below, the rate of delinquency in the portfolio would be 3.4 percent.

Rentals receivable	\$ 94,411
Est. residual value	<u>705,882</u>
Gross investment	800,293
Less:	
Unearned income	647
Unearned income (ERV)	<u>441</u>
Net investment	\$799,205
$\frac{\$3,210 - 22}{\$94,411 - 647} = 3.4\%$	

### Termination of a Lease

The termination of a lease is recognized in the income of the period in which the termination occurs by eliminating the remaining net investment from the lessor's account. The lease property is then recorded as an asset using the lower of the original cost, present fair value, or present carrying amount.

## LEVERAGED LEASES

Leveraged leasing is a specialized form of financing and should only be pursued by banks with the appropriate expertise. Part of the examiner's duty is to determine that the personnel who structure and follow leveraged leases are highly qualified in that area and have a current working knowledge of applicable tax laws and regulations.

A leveraged lease transaction is complex in terms of size, the number of parties involved, legal involvement, and, of course, the unique advantages to all parties. Legal expenses and administrative costs associated with leveraged leasing limit its use to financing large capital-equipment projects. By tailoring the tax effects to the needs of the parties involved, the structure

of a leveraged lease permits multiple tax benefits and maximum investment return. The lessor is in search of a tax shelter to offset income generated from other sources, while the lessee bargains for lower rental charges in exchange for the tax advantage the lessor receives. The result of this trade-off ideally produces an attractive rate of return on the lessor's invested dollars, while the lessee conserves working capital and obtains financing at a cost substantially below the lessee's usual borrowing rate.

In a leveraged lease, the lessor purchases and becomes owner of the equipment by providing only a percentage (usually 20 to 40 percent) of the capital needed. The rest of the purchase price is borrowed by the lessor from long-term lenders on a nonrecourse basis. The borrowings are secured by a first lien on the equipment, an assignment of the lease, and an assignment of the lease payments.

If the purchase price of the equipment is large, there may be several equity owners and debtholders involved. In this case, an owner trustee may be named to hold title to the equipment and to represent the equity owners. An indenture trustee may be named to hold the mortgage on the property for the benefit of the debtholders.

The lessor (equity holder), as the owner, is allowed to take accelerated depreciation based on the total cost of the equipment. The lessor might also receive a small portion of the rental payments, but the desired yield is obtained from the timing of depreciation. The effect gives the lessor a return through the small rentals and allows the lessor to retain the residual value rights to the equipment at the end of the lease period.

The bank should consider its present and anticipated future tax position, its future money rates, and the residual value of the property. The return on the bank's investment in leveraged leases depends largely on these factors. A slight change can precipitate significant changes in the bank's position. Anticipated proceeds from the sale or re-leasing of the property at the conclusion of the lease term (the residual value) is an important element of the return and should be estimated carefully. It will, in most cases, exceed 25 percent of the purchase price because of certain tax requirements. The bank should continually evaluate the property for misuse, obsolescence, or market decline, all of which can rapidly deteriorate the value of the property before the lease term expires. In these cases, the

lessee may default, often with expensive consequences for the lessors.

The examiner should remember that a portion of the bank's recapture of its investment in leased property is often predicated on the inherent tax benefits. Accordingly, a decline in the bank's ability to use these tax benefits could reduce or eliminate the profitability of the venture.

The complexity of leveraged leasing should motivate the examiner to carefully scrutinize each indenture and all parties concerned before any analysis begins. The examiner should approach each lease from the standpoint of the creditworthiness of the lessee and the continuous assessment of the value of the leased property. If the lessee defaults, the loan participant is

in a position to foreclose and leave the bank without a way to recapture the carrying value of its investment. Therefore, the general rule is that a bank should not enter into a leveraged lease transaction with any party to which it would not normally extend unsecured credit.

The lessor's net investment in a leveraged lease shall be recorded in a manner similar to that for a direct financing lease, but net of the principal and interest on the nonrecourse debt. The components of the net investment, including related deferred taxes, should be fully disclosed in the footnotes to the lessor's financial statements when leveraged leasing is a significant part of a bank's business activities. (See appendix E of FASB 13 for an example of how to account for a leveraged lease.)

# Direct Financing Leases

## Examination Objectives

Effective date May 1996

## Section 2120.2

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1. To determine if lease policies, practices, procedures, objectives, and internal controls are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the adequacy of collateral, credit quality, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

# Direct Financing Leases

## Examination Procedures

Effective date March 1984

## Section 2120.3

1. If selected for implementation, complete or update the Direct Financing Leases section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control" and determine if corrections have been accomplished.
4. The following information should be available at the start of the examination:
  - a. trial balance of all leases and outstanding credits
  - b. listing of accounts on which payments are delinquent 30 days or more or on which payments are otherwise not being made according to schedule
  - c. listing of available lines of credit
  - d. minutes of board and executive meetings since the date of the previous examination
5. Using an appropriate sampling technique, select leases for review.
6. Obtain liability and other information on common borrowers from examiners assigned cash items, overdrafts, and other loan areas and together decide who will review the borrowing relationship.
7. For leases selected for review, analyze the creditworthiness of the lessees. Consideration is given to the figures derived from the lessee's financial statements, as well as to cash flow, trends and projections of growth in sales and income, and the qualifications of management. Delinquency on a lease obligation is potentially more serious than delinquency on a conventional loan because, if the property under lease is necessary for the lessee's continued production of income, as is frequently the case, the lessee's financial condition will be seriously deteriorated before the lessee is willing to risk losing the property by default.
8. For those leases which might result in loss to the lessor or for which financial information was not adequate to make such a determination, transcribe the following information to line cards:
  - a. name and line of business of lessee
  - b. name of guarantor(s)
  - c. original date of the lease contract
  - d. original amount of the rentals receivable
  - e. ERV of the property
  - f. amount of ITC to be realized
  - g. book value of the investment in the lease as of the examination date
  - h. cost of the property
  - i. description and location of the property
  - j. amount and frequency of rental payments
  - k. original amount, term, rate, and schedule of amortization of any nonrecourse debt associated with the lease
  - l. lessor's percentage of equity participation in the lease obligation, if applicable
  - m. summary financial data indicating the creditworthiness of the lessee and guarantors, if applicable
9. Before the conclusion of the examination, discuss with management all classified leases. Inadequate or negative cash flow and unfavorable trends reflected in financial statements of the lessee are usually indicative of a substandard lease. Leases classified doubtful typically include those on which payments are delinquent for an extended period and those on which the lessor's recovery of investment is dependent upon an event of unknown probability, such as a pending lawsuit or insurance claim. A loss classification results from the lessee's inability or refusal to continue making payments.
10. Prepare write-ups to support the classifications. The write-up should include the lessee's type of business, present financial status, circumstances that led to the classification, the probability that the terms of the lease can be met, and the amount of protection afforded by sale or release of the underlying property.
11. Review a sample of the lessor's computations of lease yields to determine whether the lessor will recover the cost of purchasing and the after-tax cost of financing the

property during the initial term of the lease or 40 years, whichever is less.

Shown below are the amounts which may be applied against the purchase and financing costs in calculating recovery.

- a. Total of lease payments and ERV, reduced by the estimated taxes to be paid on unearned income. The amount of the ERV used in this calculation may not exceed 20 percent of acquisition cost, though it is permissible for the ERV to be carried on the books in an amount exceeding 20 percent of cost.
- b. ITC to be realized by the lessor.
- c. Tax benefits resulting from depreciation charges, equal to total allowable depreciation times the lessor's marginal tax rate. Depreciation for tax purposes is calculated on the basis of total original cost ignoring ERV. However, over time, accumulated depreciation may not exceed original cost less ERV.
- d. For personal property leases of seven years or less, any additional amount provided by an unconditional guarantee of the lessor's full recovery of investment plus financing cost. The guarantee can be made by a lessee, an independent third party, or manufacturer deemed creditworthy by the lessor. In determining full-payout compliance, the guarantee may only account for up to 60 percent of the acquisition cost of the property.

The following example of a payout calculation assumes a marginal tax rate of 46 percent and depreciation of the full cost of the property for tax purposes:

Total lease payments	\$154,080
ERV	24,000
ITC (tax benefit)	12,000
Depreciation—tax benefit (46% × 120,000)	55,200
Subtotal	\$245,280
Less taxes on unearned income:	
("interest")	\$34,080
(ERV)	24,000
46% × \$58,080	26,717
	<u>\$218,563</u>

After deducting the \$120,000 cost of the property from the net cash flow provided by the lease, after-tax funds of \$98,563 are available to cover the cost of financing the property. Dividing this amount by the assumed marginal tax rate of 46 percent indicates that the equivalent amount in pre-tax funds is \$214,267. If this \$214,267 were paid as interest over a 96-month period to finance the acquisition of property costing \$120,000, the annual rate of interest (internal rate of return) would be 32.0 percent (see compound interest chart). No further calculation need be made since this high percentage based on funds available to cover finance costs would exceed by far the lessor's likely approximate pre-tax cost of funds. However, in those instances in which the percentage calculated is believed to closely approximate the cost of funds, the lessor should be asked to explain the manner by which its recovery of cost is assured.

If this example were a personal property lease with a term of seven years or less, any qualified guarantee up to 60 percent of acquisition cost could have been considered as an addition to the funds available to provide the lessor with full payout.

As mentioned in the introduction to this section, an exception to the full-payout requirement is made for leases to those governmental entities that are prohibited from entering into leases for periods exceeding one year. In the case of leases to government entities, the lessor should demonstrate that the lease is expected to be continually renewed until the cost is fully recovered.

- 12. Review records to determine that the lease transaction constitutes a valid lease for tax purposes. If the agreement is ruled by the IRS to be a "conditional sale," the lessor would not be entitled to depreciation charges or the ITC, and the lessee would be required to deduct depreciation charges rather than lease payments from taxable income. It is preferable that the lessor obtain a private ruling from the IRS to make certain that it qualifies as the original user of the property and is therefore entitled to the previously mentioned tax benefits. Circumstances that the IRS considers as evidence of a conditional sale rather than a lease are as follows:
  - a. portions of the rental payments are made



- applicable to an equity interest of the lessee in the property
- b. the lessee acquires title to the property after making a specified number of payments
  - c. the payments made by the lessee for a short period of use constitute an unusually large percentage of the purchase price of the property
  - d. the total rental payments to be received exceed the current fair rental value of the property, indicating that the payments include an element other than rent
  - e. the lessee has an option to purchase the property at a price that is nominal in relation to the value of the property or to the total amount of rental payments
  - f. a portion of each rental payment is readily identifiable as the equivalent of interest
13. Ascertain whether title to the property rests with the lessor and that the lessor has taken steps to protect its ownership rights. Evidence of filing under the Uniform Commercial Code, where appropriate, should be found in the documentation file. Aircraft should be registered with the FAA, interstate vehicles with the ICC, and ships with the Coast Guard.
14. Check for cancellation or other provisions in the contract that could jeopardize the full-payout status of the lease. There is no need to take exception to a cancellation provision that provides for payment by the lessee of an amount that allows the lessor to fully recover its investment in the property.
15. Check that insurance coverage on leased property is provided by the lessee in compliance with all insurance provisions of the contract in an amount sufficient to protect against loss from property damage. Public liability insurance should also be provided to protect against loss from lawsuits that could arise from situations such as the crash of leased aircraft.
16. Review the lessee's duties under the contract with respect to repairs and taxes. Determine whether the lessor has instituted procedures to check that the lessee's required duties are being performed.
17. Review the status of all property acquired for lease purposes but which is not now under lease. Determine the reason for the "off-lease" status of the property, ascertain the realizable value of the property, and investigate whether the off-lease property will be sold or re-leased within the required two-year period.
18. Investigate the lessor's procedures for periodic review of the reasonableness of the estimated residual value. The estimate should be reviewed at least annually and reduced in amount on the books if the value has declined on a presumably permanent basis.
19. Review past operations of the lessee company to determine if projections of income and ERV have been realistic in light of actual experience.
20. Review the minutes of the meetings of the board and executive committees to determine whether purchases of property and delinquent leases are reported to the board.
21. Determine if the bank has entered into leases with companies owned or controlled by any director or officer. Compare the rates and terms on such leases to the rates and terms offered on leases to companies of similar credit standing.
22. Check for lease concentrations to any one lessee or industry and prepare a comment for the examination report if any concentration is considered unwarranted.
23. Determine whether the bank has established limits for the maximum amount of "credit" to be extended to a single lessee. If these limits have been established, investigate whether the bank adheres to them. If they have not been established, inquire as to the bank's policy on this matter.
24. Check for action taken on matters criticized in the most recent audit reports and the previous examination report. Determine if leases classified "loss" were removed from the books.
25. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of—
- a. delinquent leases, including those considered "A" paper;
  - b. violations of laws and regulations;
  - c. leases not supported by current and complete financial information;
  - d. leases on which documentation is deficient;
  - e. equipment deficiencies revealed in inspection reports;
  - f. off-lease equipment;
  - g. concentrations of leases;
  - h. classified leases; and

- i. leases to major shareholders, employees, officers, directors, and/or their interests.
- 26. Update workpapers with any information that will facilitate future examinations.

# Direct Financing Leases

## Internal Control Questionnaire

Effective date March 1984

## Section 2120.4

Review the bank's internal controls, policies, practices, and procedures for making and servicing direct lease financing. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES AND OBJECTIVES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written direct lease financing policies that—
  - a. establish procedures for reviewing direct lease financing applications,
  - b. define qualified property, and
  - c. establish minimum standards for documentation?
2. Are direct lease financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary direct lease financing records performed or reviewed by persons who do not also—
  - a. issue official checks and drafts or
  - b. handle cash?
- \*4. Are the subsidiary direct lease financing records reconciled, at least monthly, with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?
5. Are delinquent account collection requests and past-due notices checked to the trial balances that are used in reconciling subsidiary records of direct lease receivables to general ledger accounts, and are they handled only by persons who do not also handle cash?
6. Are inquiries about lease balances received and investigated by persons who do not also handle cash or pass adjustments?
- \*7. Are documents supporting recorded credit

adjustments checked or tested subsequently by persons who do not also handle cash or initiate transactions (if so, explain briefly)?

### INTEREST AND/OR RENT

- \*8. Is the preparation and posting of interest and/or rent records performed or reviewed by persons who do not also—
  - a. issue official checks and drafts or
  - b. handle cash?

### DEPRECIATION (OPERATING LEASES)

9. Is the preparation and posting of periodic depreciation records performed or reviewed by persons who do not also have sole custody of property?
10. Do the bank's procedures require that depreciation expense be charged at least quarterly?
- \*11. Are the subsidiary depreciation records balanced, at least quarterly, to the appropriate general ledger controls by persons who do not also have sole custody of property?

### OTHER

- \*12. Are periodic property inventory reports prepared by the lessee or trustee?
13. Do reports clearly indicate the condition and location of the leased property?
14. When inspection of the equipment leased is either infrequent or not feasible, has the bank taken measures to protect its equipment and prevent its misuse?
15. At lease termination, are outside appraisals made of property before bids are accepted?
16. Are review procedures in effect to maintain the necessary insurance coverage on all leased assets regardless of whether the cost of this insurance is to be borne by the bank or the lessee?
17. Does the bank have insurance coverage against its potential public liability risk as owner/lessor of the property?

18. Are safeguards in effect to prevent the possibility of conflict of interest or self-dealing in selecting the seller, servicer, insurer, or purchaser for the equipment leased?
19. Are separate files maintained for each lease transaction?
20. Does each file supporting the acquisition and disposal of assets reflect the review and written approval of an officer other than the person who actually controlled the disbursement and receipt of funds?
21. Are all leases required to be supported by current credit information?
22. Do modifications of terms require the approval of the board or committee that initially approved the lease?
23. If commitments are issued contingent upon receipt of certain satisfactory information, has authority to reject or accept such information been vested in someone other than the account officer?
24. Is residual value substantiated by periodic appraisals?
25. Are reports listing past-due leases and/or those receiving special attention submitted to the board for review at their regular meetings?

## CONCLUSION

26. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
27. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

### INTRODUCTION

This section applies to most types of loans found in a consumer loan department. Consumer credit, also referred to as retail credit, is defined as credit extended to individuals for household, family, and other personal expenditures, rather than for use in a business or for home purchases. Consumer credit loans are loans not ordinarily maintained by either the commercial or real estate loan departments. Consumer loans frequently make up the largest number of loans originated and serviced by the bank, but their dollar volume may be significantly less than for other types of loans. Consumer credit loans may be secured or unsecured and are usually structured with short- or medium-term maturities. Broadly defined, consumer credit includes all forms of *closed-end credit (installment credit)* and *open-end credit (revolving credit)*, such as check credit and credit card plans. Consumer credit also includes loans to individuals secured by their personal residence, including home equity and home-improvement loans. Home equity loans are discussed in “Real Estate Loans,” section 2090.1.

The examiner should determine the adequacy of the consumer credit department’s overall policies, procedures, and credit quality. The examiner’s goal should not be limited to identifying current portfolio problems but should include potential problems that may result from liberal lending policies, unfavorable trends, potentially imprudent concentrations, or non-adherence to established policies. Banks lacking written policies, or failing to implement or follow established policies effectively, should be criticized in the report of examination.

### TYPES OF CONSUMER CREDIT

#### Installment Loans

Many traditional forms of installment credit have standard monthly payments and fixed repayment schedules of one to five years. These loans are made with either fixed or variable interest rates that are based on specific indices. Installment loans fill a variety of needs, such as financing the purchase of an automobile or household appliance, financing home improvement, or consolidating debt. These loans may be

unsecured or secured by an assignment of title, as in an automobile loan, or by money in a bank account.

A bank’s installment loan portfolio usually consists of a large number of small loans, each scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases; however, amortizing commercial loans are sometimes placed in the installment loan portfolio to facilitate servicing. In addition, the installment loan portfolio can consist of both loans made by the bank and loans purchased from retail merchants who originated the loans to finance the sale of goods to their customers.

#### *Indirect Installment Loans*

Indirect installment loans are also known as dealer loans, sales-finance contracts, or dealer paper. In this type of consumer credit, the bank purchases, sometimes at a discount, loans originated by retailers of consumer goods, such as a car dealer. This type of lending is called indirect lending because the dealer’s customer indirectly becomes a customer of the bank.

The sales-finance contracts purchased from dealers for consumer goods are generally closed-end installment loans with a fixed rate of interest. These loans are purchased in one of three ways depending on the dealer and the circumstances of purchase:

- *Without recourse.* The bank is responsible for collecting the account, curing the delinquency, or applying the deficiency against dealer reserves or holdback accounts. The majority of sales-finance contracts with dealers are without recourse.
- *Limited recourse.* The dealer will repurchase the loan, cure the default, or replace the loan only under certain circumstances in accordance with the terms of the agreement between the bank and the dealer.
- *With recourse.* The dealer is required to repurchase the loan from the bank on demand, typically within 90 to 120 days of default.

In the cases of recourse and limited recourse loans, legal lending limitations need to be considered.

Sales-finance contracts purchased from dealers without recourse should be based on the

individual's creditworthiness, *not* on the financial strength of the dealership itself. The contracts purchased should comply with the bank's loan policy for similar consumer loans. Exceptions to the bank's policies and procedures should be documented in the credit file and have the appropriate level of approval. For sales-finance contracts purchased with recourse that do not meet the bank's normal credit criteria and are purchased based on the added strength of the dealer, the bank should document the minimum criteria for such loans and the specific bank-approved financial covenants with which the dealer must comply.

## Check Credit

Check credit is defined, for the purpose of this manual, as the granting of unsecured, interest-bearing, revolving lines of credit to individuals or businesses. Banks provide check-credit services by overdraft protection, cash reserves, and special drafts.

The most common product is overdraft protection, whereby a transfer is made from a preestablished line of credit to a customer's deposit account when a check is presented that would cause the account to be overdrawn. Transfers normally are made in specific increments, up to a maximum line of credit approved by the bank.

In a cash-reserve system, the customer must request that the bank transfer funds from a preestablished line of credit to his or her deposit account. To avoid overdrawing the account, the customer must request the transfer before negotiating a check against the account.

In a special draft system, the customer negotiates a special check drawn directly against a preestablished line of credit. In this method, deposit accounts are not affected.

In all three systems, the bank periodically provides its check-credit customers with a statement of account activity. Required minimum payments are computed as a fraction of the balance in the account on the cycle date and may be made by automatic charges to the deposit account.

Delinquencies are often experienced when an account is at or near the customer's maximum credit line. Examiners should verify that the following reports are generated for and reviewed by bank management, and they should also analyze them as part of the examination process:

- aging of delinquent accounts
- accounts on which payments are made (either on this account or other loans) by drawing on reserves
- accounts with steady usage

Many banks offer check-credit plans to small businesses; these plans may contain a higher-than-normal degree of risk unless they are under very stringent controls. In these situations, the examiner's review should be based on the same factors and criteria used in the review of unsecured commercial loans.

## Credit Card Plans

Most bank credit-card plans are similar. The bank solicits retail merchants, service organizations, and others who agree to accept a credit card in lieu of cash for sales or services performed. The bank assumes the credit risk and charges the nonrecourse sales draft to the individual customer's credit card account. Monthly statements are sent by the bank to the customer, who may elect to pay the entire amount or to pay in monthly installments, with an additional percentage charge on the outstanding balance each month. A cardholder may also obtain cash advances, which accrue interest from the transaction date, from the bank or automated teller machines.

There are various ways that a bank can be involved in a credit card plan. Also, the terminology used to describe the manner in which a bank is involved in a credit card plan may vary. The examiner first needs to determine the type of credit card plan that the bank has and then ascertain the degree of risk that the plan poses to the bank.

Potential risk in the credit card department generally is divided into two categories: the misuse of credit and the misuse of the credit card. The potential for credit misuse is reduced by careful screening of cardholders before cards are issued and by monitoring individual accounts for abuse. Credit card misuse may be reduced by establishing controls to prevent the following:

- employees or others from intercepting the card before delivery to the cardholder
- merchants from obtaining control of cards
- fraudulent use of lost or stolen cards

Because credit cards may be easily misused by the cardholders and others who may obtain use of the cards, strict adherence to appropriate internal controls and operating procedures is essential in any credit card department. The examiner should determine if adequate controls and procedures exist.

The examiner should review the bank's credit card receivables to determine if *re-aging* occurs. Re-aging refers to the removal of a delinquent account from the normal collection activity after it has been demonstrated over time that the borrower is capable of fulfilling contractual obligations without the intervention of the bank's collection department. The bank may use re-aging when a customer makes regular and consecutive payments over a period of time that maintain the account at a consistent delinquency level or reduce the delinquency level with minimal collection effort. Re-aging, in effect, forgives past-due credit amounts, but leaves an outstanding balance on the account. The examiner should determine if the bank re-ages its accounts on an exception basis or as a regular practice. The bank should document those accounts which have been re-aged, obtain appropriate approval, and ensure that re-aging is done in conformance with internal policies and procedures. See the "Bank Classification and Charge-Off Policy" subsection below and SR-99-5 for further guidance.

## LOAN POLICY

A written consumer credit policy provides bank management with the framework to underwrite and administer the risk inherent in lending money while establishing a mechanism for the board of directors or senior management to monitor compliance. The policy should establish the authority, rules, and guidelines to operate and administer its consumer loan portfolio effectively; that is, it should help manage risk while ensuring profitability. The policy should set basic standards and procedures clearly and concisely. The policy's guidelines should be derived from a careful review of internal and external factors that affect the bank. In addition, the policy should include guidelines on the various consumer credit laws and regulations to avoid any discriminatory policies or practices.

The composition of the loan portfolio will differ considerably among banks because lend-

ing activities are influenced by many factors, including the type of institution, management's objectives and philosophies on diversification and risk, the availability of funds, and credit demand. An effective lending policy and commensurate procedures are integral components of the lending process. The bank's consumer credit policy should—

- define standards, rules, and guidelines for the credit evaluation process, with the following specific goals:
  - establish minimum and maximum loan maturities
  - establish minimum levels of creditworthiness
  - create consistency within the bank's underwriting process
  - ensure uniformity in how the bank's consumer credit products are offered to borrowers;
- define procedures for handling delinquent consumer credit loans and the subsequent charge-off of those loans;
- provide a degree of flexibility, which allows credit officers and management to use their knowledge, skills, and experience;
- provide specific guidelines for determining the creditworthiness of applicants, which might include the following:
  - minimum income levels
  - maximum debt-to-income ratios
  - job or income stability
  - payment history on previous obligations
  - the type and value of collateral
  - maximum loan-to-value ratios on various types of collateral
  - a minimum score on a credit scoring system;
- provide guidelines for the level and type of documentation to be maintained, including—
  - a signed application;
  - the identity of the borrower and his or her occupation;
  - documentation of the borrower's financial capacity;
  - a credit bureau report;
  - the purpose of all loans granted to the borrower, the sources of repayment, and the repayment programs;
  - documentation of the collateral, its value, and the source of the valuation;
  - documents perfecting the lien on the collateral;

- verification worksheets and supporting documentation;
- a credit scoring worksheet, if applicable;
- the sales contract and related security agreements, if applicable;
- evidence of insurance coverage, if applicable; and
- any other documentation received or prepared in conjunction with the credit request.

The consumer credit policy should also provide guidelines for granting loans that do not conform to the bank's written lending policy or procedures. The policy should require that the reason for the exception be detailed in writing, submitted for approval to a designated authority, and documented in the loan file. Credit exceptions should be reviewed by the appropriate bank committee. The frequency of exceptions granted may indicate a lessening of underwriting standards or a need to adjust the policy to allow flexibility within safe and sound parameters. The examiner should assess the exceptions and make recommendations accordingly.

Obtaining and maintaining complete and accurate information on every consumer credit applicant is essential to approving credit in a safe and sound manner. The loan policy should establish what information will be required from the borrower during the application process and what, if any, subsequent information the borrower will be required to submit while the credit remains outstanding. Credit files should be maintained on all borrowers, regardless of the credit amount, with the exception of the latitude provided by the March 30, 1993, Interagency Policy Statement on Documentation of Loans. Each borrower's credit file should include the names of all other borrowers who are part of the same borrowing relationship, or the bank should have some other system for informing the reader of a credit file that the borrower is part of a credit relationship. A current credit file should provide the loan officer, loan committee, and internal and external reviewers with all information necessary to analyze the credit before it is granted and to monitor the credit during its life.

Documentation requirements will vary according to the type of loan, borrower, and collateral. For example, the bank may not require a financial statement from a borrower whose loans are fully secured by certificates of deposit issued by the bank. For most consumer credit loans, the borrower's financial information is collected only at the time of the loan application.

## OPERATIONAL RISK

Management of the consumer credit function and the accompanying internal controls are of primary importance to the safe, sound, and profitable operation of a bank. In evaluating controls for consumer credit administration, the examiner should review (1) the bank's adherence to policies and procedures and (2) the operational controls over recordkeeping, payments, and collateral records to ensure that risks are controlled properly. See "Loan Portfolio Management," section 2040.1, for an overview of the various types of risk that the bank should be aware of and the controls it should implement to effectively manage risk.

Risks that are inherent to the consumer credit function and that require internal controls include, but are not limited to, the following:

- *Insurance.* All insurance policies on file should name the bank as loss payee. The bank should maintain a tickler system to monitor the expiration of insurance policies. In addition, the bank should implement procedures to ensure single-interest insurance coverage is obtained in case the borrower's insurance is canceled or expires.
- *Security agreements.* The bank should implement procedures to ensure that lien searches are performed and that liens are perfected by appropriate filings.
- *Indirect installment loans.* The bank should implement procedures to reduce the risk that can occur in this area. These procedures should ensure the following:
  - payments are made directly to the bank and not through the dealer
  - dealer lines are reaffirmed at least annually
  - selling prices as listed by the dealer are accurate
  - credit checks on the borrowers are performed independently of the dealer
  - overdrafts are prohibited in the dealer-reserve and holdback accounts
  - past-due accounts are monitored in aggregate per dealer to access the quality of loans received from each individual dealer

## CREDIT SCORING SYSTEM

Credit scoring is a method for predicting how much repayment risk consumer credit borrowers



present. Credit scoring systems are developed using application and/or credit bureau data on consumers whose performance has already been categorized as creditworthy or noncreditworthy. Items of information that help predict acceptable performance are identified and assigned point values relative to their overall importance. These values are then totaled to calculate an overall credit score.

The credit score is used to approve credit, frequently avoiding the costly and time-consuming process of individual underwriting. Management determines a minimum score, which is sometimes called the cutoff score. Borrowers whose credit scores are not within the approved cutoff-score range for the type of loan requested do not meet the bank's minimum underwriting criteria. However, the bank may override a borrower's unacceptable credit score when other mitigating factors are present that may not have been included in the credit score. Exceptions to the bank's credit scoring system should be documented.

A number of banks have developed and implemented credit scoring systems as part of the approval process for consumer credit, while other banks use traditional methods that rely on a credit officer's subjective evaluation of an applicant's creditworthiness. Credit scoring systems are replacing credit officers' subjective evaluation of borrowers' creditworthiness in more and more banks, particularly in larger institutions. Credit scoring systems are divided into two categories: (1) empirically derived, demonstrably and statistically sound credit systems and (2) judgmental systems.

Empirically derived credit scoring systems are generally defined as systems that evaluate creditworthiness by assigning points to various attributes of the applicant and, perhaps, to attributes of the credit requested. The points assigned are derived from a statistical analysis of recent creditworthy and noncreditworthy applicants of the bank. An empirically derived credit scoring system is statistically sound when it meets the following requirements:

- The data used to develop the system are derived from an empirical comparison of sample groups or from the population of creditworthy and noncreditworthy applicants who applied for credit within a reasonably recent period of time.
- The system is developed to evaluate the creditworthiness of applicants to serve the legiti-

mate business interests of the bank using the system.

- The system is developed and validated using statistical principles and methodology.
- The bank periodically reevaluates the predictive ability of the system using statistical principles and methodologies, and adjusts it as necessary.

An empirically derived credit scoring system may take the age of an applicant into account as a predictive variable, provided that the age of an elderly applicant is not assigned a negative factor or value. In a judgmental system, which relies on a credit officer's personal evaluation of a potential borrower's creditworthiness, a creditor may not take age directly into account. However, the applicant's age may be related to other information that the creditor considers in evaluating creditworthiness. For example, a creditor may consider the applicant's occupation and length of time to retirement to ascertain whether the applicant's income (including retirement income) will support the extension of credit to maturity. Consumer credit regulations allow any system of evaluating creditworthiness to favor an applicant who is 62 or older.

If the bank has a credit scoring system, the examiner should review the items or customer attributes that are included in it. In general, credit scoring systems are built on an experiential or historical database. Credit scoring methods analyze the experiences of individuals who have been previously granted credit and divides them into creditworthy and noncreditworthy accounts for purposes of predicting future extensions of consumer credit.

A successful credit scoring system provides a standardized way of measuring the inherent risk of the borrower. An important measure of any credit scoring system is its definition of risk and the care with which explanatory variables are defined, data are collected, and the system is tested. The standardized risk measurement should be fundamentally sound, be based on historical data, measure the risk of default (or loss), and produce consistent results across time for a wide range of borrowers. The bank should further investigate potential borrowers who do not meet the credit scoring criteria.

Some banks may use more than one type of credit scoring methodology in their underwriting and account-management practices. The

following are three examples of credit scoring systems:

- *Credit bureau scoring.* The bank uses a consumer's credit bureau information in a scoring formula. The scoring model is developed by the various credit bureaus, using the reported experience of all credit grantors with whom the applicant has or has had a relationship.
- *Custom application scoring.* The bank uses both a consumer's application and credit bureau data in a scoring formula. This scoring model is developed using only information on the bank's applicants and borrowers.
- *Behavioral scoring.* The bank uses a formula that includes a borrower's repayment history, account utilization, and length of time with the bank to calculate a risk score for revolving accounts.

Applicants who fail the scoring process may still be judgmentally reviewed if additional information exists that may not have been included in the scoring formula. In addition, if an applicant passes the scoring process, but other information indicates that the loan should not be made, the applicant can be denied, but the reason for the credit denial should be documented.

## BANK CLASSIFICATION AND CHARGE-OFF POLICY

Consumer credit loans, based on their volume and size, are generally classified using criteria different from the classification of other types of loans. The examiner should use the Retail-Credit Classification and Account-Management Policy<sup>1</sup> when determining consumer credit classifications. The bank should have procedures detailing when consumer credit loans become watch-list or problem credits. In addition, the bank should have charge-off procedures for consumer credit loans. The examiner should review the bank's policies and procedures for adequacy and compliance.

Identification of unfavorable trends must include the review of past-due percentages and income and loss trends in the consumer credit department, which management should monitor

closely. Unfortunately, in banks that lack a well-enforced charge-off program, loss ratios are often meaningless for periods of less than a year. As a result, bank management may not become aware of downward trends until year-end or examiner-initiated charge-offs are made. Recognition and implementation of any necessary corrective action are thus delayed.

The examiner should determine whether the bank has adopted a well-enforced charge-off procedure. If so, his or her review should be limited to ascertaining that exceptions meet established guidelines. If the bank is properly charging off delinquent consumer credit loans in the normal course of business under a policy that generally conforms to that of the Federal Reserve System, no specific request for charge-off should be necessary. When the bank has not established a program to ensure the timely charge-off of delinquent accounts, such a program should be recommended in the examination report. If material misstatements in the Reports of Condition and Income for previous quarters have resulted from management's failure to charge off loans, management should be instructed to amend the Reports of Condition and Income for each affected quarter. The following loans are subject to the uniform classification policy:

- All loans to individuals for household, family, and other personal expenditures as defined in the "Instructions for the Preparation of Reports of Condition."
- Mobile home paper, except when applicable state laws define the purchase of a mobile home as the purchase of real property, and the loan is secured by the purchased mobile home as evidenced by a mortgage or similar document.
- Federal Housing Authority (FHA) title 1 loans. These loans are also subject to the following classification criteria:
  - Uninsured portions should be charged off when claims have been filed.
  - When claims have not been filed, uninsured delinquent portions should be classified in accordance with the delinquent installment loan classification policy.
  - The portion covered by valid insurance is not subject to classification.

These guidelines for consumer credit loans should be observed on small, delinquent loans, and they may be listed for classification purposes in the report of examination without

1. This policy was issued in February 1999 but implementation is not required until December 31, 2000.

detailed comments. Larger classified consumer loans might need to be supported with detailed comments.

In cases for which no specific procedures have been established, or when adherence to the established procedures is not evident, the examiner should make every effort to encourage the bank to adopt and follow acceptable procedures.

## RETAIL-CREDIT CLASSIFICATION POLICY

Evidence of the quality of consumer credit soundness is indicated best by the repayment performance of the borrower. Because retail credit generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail-credit portfolio on a loan-by-loan basis is inefficient and burdensome for both the institution being examined and examiners. Therefore, retail credit should generally be classified based on the following criteria:

- Open-end and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified substandard.<sup>2</sup>
- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be charged off. The charge-off should be taken by the end of the month in which the 120- or 180-day time period elapses.<sup>3</sup>
- In general, unsecured retail loans to borrowers who declare bankruptcy should be charged off within 60 days of receipt of notification of the bankruptcy filing. Any loan balance not charged off should be classified substandard until the borrower reestablishes the ability and willingness to repay (with demonstrated payment performance for six months at a minimum) or there is a receipt of proceeds from liquidation of collateral.
- Fraudulent loans should be charged off within 90 days of discovery.
- In the case of a borrower who dies and when

repayment within the required timeframe is uncertain, the loan should generally be charged off when the loss is determined, but in no case should the charge-off of a decedent's loan exceed the general charge-off timeframes (that is, 180 days for open-end credit and 120 days for closed-end credit).

- One- to four-family residential real estate loans and home equity loans that are delinquent 90 days or more with loan-to-value ratios greater than 60 percent should be classified substandard. If delinquency exceeds the general charge-off timeframes for open-end and closed-end loans, the institution should evaluate its collateral position and classify as loss any loan amount that exceeds the value of the collateral.
- When a residential or home equity loan is 120 days past due for closed-end credit and 180 days past due for open-end credit, an assessment of the current value should be made, and any outstanding loan balance in excess of the fair value of the property, less cost to sell, should be classified loss.

Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. If an institution has extended both a home equity loan and a senior mortgage loan to the same borrower and the combined loan-to-value ratio is equal to or less than 60 percent, the home equity loan should not be classified if delinquent. However, home equity loans in which the institution does not hold the senior mortgage and that are delinquent 90 days or more should be classified substandard, even if the loan-to-value ratio is equal to or less than 60 percent.

## Other Considerations for Classification

If an institution can clearly document that a delinquent loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan does not need to be classified. A well-secured loan is one that is collateralized by real or personal property, including securities, with an estimated fair value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that

2. Examiners need to be aware that consumer credit loans on which payments have not been made for up to 29 days after the due date are not considered delinquent. This is often referred to as the grace period.

3. Fixed-payment open-end retail accounts that are placed on a closed-end repayment schedule should follow the closed-end charge-off time frames.

amount. “In the process of collection” means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

An institution is not precluded from adopting an internal classification policy more conservative than the one detailed above. This policy also does not preclude examiners from using the doubtful or loss classifications in certain situations if a rating more severe than substandard is warranted. Loss in retail credit should be recognized when the institution becomes aware of the loss, but in no case should the charge-off exceed the timeframes noted above.

### Partial Payments on Open-End and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing delinquency. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular monthly installment payment is \$300 and the borrower makes payments of only \$100 per month for a six-month period, the shortage would be \$1,200 (\$200 times six payments), or four full months delinquent. An institution may not use both methods simultaneously with the same loan.

### Re-aging, Extensions, Deferrals, Renewals, or Rewrites

Re-aging is the practice of bringing a delinquent account current after the borrower has demonstrated a renewed willingness and ability to repay the loan by making some, but not all, past-due payments. Re-aging of open-end accounts, or extensions, deferrals, renewals, or rewrites of closed-end accounts, should only be used to help borrowers overcome temporary financial difficulties, such as the loss of a job, a medical emergency, or a change in family circumstances like the loss of a family member.

A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the

portfolio. However, prudent use of a policy is acceptable when it is based on recent, satisfactory performance and on true improvement in a borrower's other credit factors, and when it is structured in accordance with the institution's internal policies.

The decision to re-age a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that institution personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower shows the ability to repay the loan.

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. An account eligible for re-aging, extension, deferral, renewal, or rewrite should exhibit the following:

- The borrower should demonstrate a renewed willingness and ability to repay the loan.
- The account should exist for at least nine months before allowing a re-aging, extension, renewal, referral, or rewrite.
- The borrower should make at least three minimum consecutive monthly payments or the equivalent lump-sum payment before an account is re-aged. Funds may not be advanced by the institution for this purpose.
- No loan should be re-aged, extended, deferred, renewed, or rewritten more than once within any 12-month period—that is, at least 12 months must have elapsed since a prior re-aging.<sup>4</sup>
- For open-end credit, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees). No new credit may be extended to the borrower until the balance falls below the designated predelinquency credit limit.

4. Currently, the Uniform Retail-Credit Classification and Account-Management Policy also provides that no loan should be re-aged, extended, deferred, renewed, or rewritten more than two times within any five-year period. However, in response to concerns expressed by the industry, it is likely that the banking agencies will reconsider this restriction. Implementation of the uniform classification and account-management policy is not required until December 31, 2000.

## Examination Considerations

Examiners should ensure that institutions adhere to the requirements of the Uniform Retail-Credit Classification and Account-Management Policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The uniform classification and account-management policy does not preclude examiners from reviewing and classifying individual large-dollar retail credit loans that exhibit signs of credit weakness regardless of delinquency status. In addition to reviewing loan classifications, the examiner should ensure that the institution's allowance for loan and lease loss provides adequate coverage for inherent losses. Sound risk- and account-management systems, including a prudent retail-credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. Internal controls should be in place to ensure that the policy is followed. Institutions lacking sound policies or failing to implement or effectively follow established policies will be subject to criticism.

## REPOSSESSED PROPERTY

Reposessed property should be booked at the lower of the recorded investment in the loan or its fair market value on the date the bank obtains clear title and possession of the property. Any excess of the recorded investment in the loan over fair value must be charged off. Periodic repricing should be performed, and appropriate accounting entries should be made when necessary. Generally, reposessed property should be disposed of within 90 days of obtaining possession, unless legal requirements stipulate a longer period.

## VIOLATIONS OF LAW

The consumer credit department is particularly susceptible to violations of the various consumer credit laws and regulations, which may result in serious financial penalties and loss of public esteem. Therefore, the examiner must be aware of any violations discovered during the consumer compliance examination and ensure that corrective action has been effected. All examiners should be familiar with the various consumer credit laws and regulations and be alert to potential violations.

# Consumer Credit

## Examination Objectives

Effective date May 1996

## Section 2130.2

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1. To determine if lending policies, practices, procedures, and internal controls regarding consumer credit are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To evaluate the portfolio for credit quality, performance, adequate collateral, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine the level of risk inherent in a bank's consumer credit department and what actions management has taken to reduce the level of risk.
6. To determine compliance with applicable laws and regulations.
7. To initiate corrective action when policies, procedures, practices, or internal controls are deficient or when violations of law or regulations have been noted.

# Consumer Credit Examination Procedures

Effective date March 1984

## Section 2130.3

1. If selected for implementation, complete or update the installment loan section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review done by internal/external auditors. If applicable, also determine if the latest consumer compliance examination disclosed any violation of laws or regulations. Determine if corrective action has been taken.
4. Request that the bank supply the following:
  - a. Listing of all dealers who have indirect paper, fleet leasing, or discounted lease lines, along with respective codes.
  - b. Indirect paper, fleet leasing, or discounted fleet leasing report by code, along with respective delinquency report for all loans overdue 30 days or more.
  - c. Listing of dealer reserves and/or hold-back accounts showing dealer, account number, and balance.
  - d. Latest month-end extension and renewal reports.
  - e. Schedule of all loans with irregular and/or balloon payments.
  - f. Schedule of all loans with more than five prepaid installments.
  - g. Listing of loans generated by brokers or finders.
  - h. Listing of current repossessions, including name of borrower, description of item, date of repossession, date title was acquired, and balance.
  - i. Copy of each monthly charge-off report submitted to the board since the preceding examination. If reports do not include all information necessary to prepare the form for charge-off of installments between examinations, request a listing of that information for each charge-off.
  - j. Management reports prepared by department personnel which are not forwarded in their entirety to the board of directors or its committee.
  - k. Listing of amount of recoveries on charged-off installment loans, by month, since the preceding examination.
  - l. Listing of all outstanding loans that are in the hands of attorneys for collection.
  - m. Identification of all columns and codes contained on the computer printout.
5. Obtain a trial balance of installment loans. Use of the bank's latest trial balance is acceptable. If exact figures are required, update the trial from the daily transaction journals. Using the trial balance:
  - a. Agree or reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
6. Using an appropriate technique, select borrowers for examination.
7. Using an appropriate technique, select indirect dealers, fleet leasing and indirect lease lines from indirect dealer/leasing reports. Transcribe the following onto consumer finance indirect line cards.
  - a. Amount and number of contracts, indicating whether with or without recourse.
  - b. Amount and number of contracts past due 30–89 days, 90–119 days, and more than 120 days.
  - c. Balance in dealer reserve and/or hold-back accounts.
8. Obtain the following schedules from the bank or the appropriate examiner if they are applicable to this area:
  - a. Past-due loans (obtain separate schedule by branch, if available).
  - b. Loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation or asset swap, since the previous examination.
  - c. Loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination.
  - d. Loan commitments and other contingent liabilities.
  - e. Extensions of credit to employees, officers, directors, principal shareholders and their interests, specifying which officers are considered executive officers.
  - f. Extensions of credit to executive offi-

- cers, directors, principal shareholders and their interests, of correspondent banks.
- g. List of correspondent banks.
- h. Miscellaneous loan debit and credit suspense accounts.
- i. Loans considered “problem loans” by management.
- j. Each officer’s current lending authority.
- k. Current interest rate structure.
- l. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee.
- m. Reports furnished to the loan and discount committee or any similar committee.
- n. Reports furnished to the board of directors.
- o. Loans classified during the preceding examination.
- p. The extent and nature of loans serviced.
- 9. Review the information received and perform the following for:
  - a. Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale/purchase, or asset swap:
    - Participations only:
      - Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
      - Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
    - Procedures pertaining to *all* transfers:
      - Investigate any situations where loans were transferred immediately prior to the date of examination to determine if any were transferred to avoid possible criticism during the examination.
      - Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
      - Determine that low-quality loans transferred to or from the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium).
  - Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
  - If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
    - Name of originating institution.
    - Name of receiving institution.
    - Type of transfer (i.e., participation, purchase/sale, swap).
    - Date of transfer.
    - Total number of loans transferred.
    - Total dollar amount of loans transferred.
    - Status of the loans when transferred (e.g., nonperforming, classified, etc.).
    - Any other information that would be helpful to the other regulator.
- b. Miscellaneous loan debit and credit suspense accounts:
  - Discuss with management any large or old items.
  - Perform additional procedures as considered appropriate.
- c. Loan commitments and other contingent liabilities:
  - If the borrower has been advised of the commitment and it exceeds the cutoff alone or in combination with any outstanding debt, prepare a line card for subsequent analysis and review.
- d. Loans classified during the previous examination:
  - Determine the disposition of loans so classified by obtaining:
    - Current balances and payment status, or the date the loan was repaid and source of payment.
    - Investigate any situations where all or part of the funds for the repay-



- ment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution.
- If repayment was a result of a participation, sale, or swap, refer to step 9a of this section for the appropriate examination procedures.
  - e. Select loans which require in-depth review based on information derived from the above schedules.
10. Consult with the examiner responsible for the Asset/Liability Management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. Refer to the Instructions for the Report of Examination section of this manual for considerations to be taken into account when compiling maturity information for the GAP analysis.
  11. Obtain liability and other information on common borrowers from examiners assigned to overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
  12. Obtain the credit files of all direct non-consumer borrowers, indirect dealers, fleet leasing, and discounted leasing lines for which line cards have been developed. Transcribe and analyze the following as appropriate:
    - a. Purpose of loan.
    - b. Collateral information, including value and bank's right to hold and negotiate.
    - c. Source of repayment.
    - d. Ancillary information, including type of business, officers, and affiliation.
    - e. Fiscal and interim financial exhibits.
    - f. Guarantors and amount of any guarantee.
    - g. Personal statements of borrowers, endorsers, or guarantors.
    - h. External credit checks and bureau reports.
    - i. Loan officer's credit memoranda.
    - j. Subordination agreements.
    - k. Corporate resolution to borrow or guarantee.
    - l. Provisions of loan agreement or master lease agreement.
    - m. Type of dealer endorsement:
      - Full recourse.
      - Limited recourse.
      - Nonrecourse.
    - n. Dealer repurchase agreements.
    - o. Reserve and holdback requirements.
    - p. Amount of insurance coverage.
  13. Check central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness, who are suspected of having additional liability in other loan areas.
  14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers on which line cards have been developed. Cross-reference, if appropriate.
  15. Review listing of loans generated by brokers or finders and:
    - a. Check the quality of the paper being acquired.
    - b. Determine that sufficient financial data have been obtained to support the credits.
    - c. Evaluate performance.
  16. Review the current past-due loan list and list of repossessed items and determine if charge-offs are being made in line with bank policy. Individual accounts which have not been charged-off in line with the general policy should be reviewed and discussed with management.
  17. Prepare a listing of delinquent accounts for discussion with management. Delinquent loans should be classified according to Federal Reserve policy.
  18. Review voluntary charge-offs made since preceding examination and, on a test basis, review files on borrowers and ascertain correctness of the charge-off.
  19. Review any reports being submitted on delinquent and defaulted loans guaranteed by government agencies and:
    - a. Determine that management is informed accurately and is complying with the reporting requirements.
    - b. Determine that claims are being promptly filed after default.
  20. Determine compliance with laws, regulations, and Federal Reserve Board policy statement pertaining to installment lending by performing the following steps for:
    - a. *Lending Limits:*
      - Determine the bank's lending limits as prescribed by state law.
      - Determine advances or combinations of advances with aggregate balances above the limit.

b. *Section 23A Federal Reserve Act (12 USC 371c)—Transactions with Affiliates:*

- Obtain a listing of loans to affiliates.
- Test check the listing against the bank's customer liability records to determine its accuracy and completeness.
- Obtain a listing of other covered transactions with affiliates (i.e., acceptance of affiliate's securities as collateral for a loan to any person).
- Ensure that covered transactions with affiliates do not exceed limits of section 23A.
- Ensure that covered transactions with affiliates meet the collateral requirements of section 23A.
- Determine that low-quality loans have not been purchased from an affiliate.
- Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.

c. *18 USC 215—Commission or Gift for Procuring Loan:*

- While examining the installment loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
- Investigate any such suspected situation.

d. *Federal Election Campaign Act (2 USC 441b)—Political Contributions:*

- While examining the installment loan area, determine the existence of any loans in connection with any election to any political office.
- Review each such credit to determine whether it is made in accordance with applicable banking laws and regulations and in the ordinary course of business.

e. *12 USC 1972—Tie-In Provisions:*

- While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon:
  - Obtaining or providing an additional credit, property, or service to or from the bank or its holding company, other than a loan, discount, deposit, or trust service.

- The customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.

f. *Insider Lending Activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):

1. *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, Principal Shareholders, and Their Interests:*

- While reviewing information relating to insiders received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps):
  - Test the accuracy and completeness of information about installment loans by comparing it to the trial balance or loans sampled.
  - Review credit files on insider loans to determine that required information is available.
  - Determine that loans to insiders do not contain terms more favorable than those afforded to other borrowers.
  - Determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features.
  - Determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections.
  - If prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained.
  - Determine compliance with the various reporting requirements for insider loans.
  - Determine that the bank has

made provisions to comply with the public disclosure requirements for insider loans.

- Determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years.
- 2. *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2))—Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks:*
  - Obtain from or request the examiners reviewing “Due from Banks” and “Deposit Accounts” to verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
  - Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.
- g. *Federal Reserve Board Policy Statement on the Disposition of Credit Life Insurance Income (67 Fed. Res. Bull. 431 (1981), FRRS 3–1556):*

Test for compliance with the policy statement in the installment loan department by determining:

- That the income generated from the sale of credit life, health, and accident insurance<sup>1</sup> is:
  - Not distributed directly to employees, officers, directors, or principal shareholders in the form of commissions or other income for their personal profit; such individuals may, however, participate in a bonus or incentive plan in an amount not exceeding in any one year 5 percent of the recipient’s annual salary, and paid not more often than quarterly.
  - For accounting purposes, credited to the bank’s income account, the income account of an affiliate operating under the Bank Holding

Company Act, or in the case of an individual shareholder, to a trust for the benefit of all shareholders.

- Whether an insurance agent or agency acted as an intermediary in arranging the bank’s credit life insurance coverage and the relationship of the agent or agency to the bank. If so, is the agent or agency in compliance with the provisions of this policy?
- Which employees, officers, directors and principal shareholders are licensed insurance agents.
- Whether bank officers have entered into reciprocal arrangements with officers of other banks to act as agent for sale of credit life insurance and to receive commissions.
- If the credit life insurance income is credited to an entity other than the bank, determine whether the bank is being appropriately reimbursed for the use of its premises, personnel, and goodwill. Compute the percentage compensation paid bank (total credit life insurance income). Include that percentage in the confidential section of the commercial report of examination. As a general rule, a reasonable compensation would be an amount equivalent to at least 20 percent of the credited entity’s net income (if available) attributable to the credit life insurance sales.
- h. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103.33)—Records to be Retained by Financial Institutions:*

Review operating procedures and credit life documentation and determine whether the bank retains records of each extension of credit over \$5,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date therefore. Loans secured by an interest in real property are exempt.
- 21. Perform appropriate procedural steps for the separate area, “Concentration of Credits.”
- 22. Discuss with appropriate officer(s) and prepare comments to the examiner-in-charge stating your findings on:
  - a. Delinquent loans, including breakout of “A” paper.
  - b. Violations of laws and regulations.

1. This policy also applies to income derived from the sale of mortgage life insurance; therefore, consult with the examiner assigned “Real Estate Loans” to coordinate work to avoid any duplication of efforts.

- c. Concentration of credits.
  - d. Classified loans.
  - e. Loans not supported by current and complete financial information.
  - f. Loans on which collateral documentation is deficient.
  - g. Inadequately collateralized loans.
  - h. Extensions of credit to major stockholders, employees, officers, directors and/or their interests.
  - i. Small Business Administration or other government-guaranteed delinquent or criticized loans.
  - j. List of installment loans requested to be charged-off.
  - k. The adequacy of written policies relating to installment loans.
  - l. The manner in which bank officers are operating in conformance with established policy.
  - m. Adverse trends within the installment area.
  - n. Accuracy and completeness of the schedules obtained from the bank or other examination areas.
  - o. Internal control deficiencies or exceptions.
  - p. Recommended corrective action when policies, practices, or procedures are deficient.
  - q. The quality of departmental management.
  - r. Other matters of significance.
23. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing installment loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

## **POLICIES**

1. Has the board of directors, consistent with its duties and responsibilities, adopted written installment loan policies that:
  - a. Establish procedures for reviewing installment loan applications?
  - b. Establish standards for determining credit lines?
  - c. Establish minimum standards for documentation?
2. Are installment loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

## **RECORDS**

- \*3. Is the preparation and posting of subsidiary installment loan records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are the subsidiary installment loan records reconciled daily to the appropriate general ledger accounts and are reconciling items investigated by persons who do not also handle cash?
5. Are delinquent-account collection requests and past-due notices checked to the trial balances that are used in reconciling installment loan subsidiary records to general ledger accounts, and handled only by persons who do not also handle cash?
6. Are inquiries about loan balances received and investigated by persons who do not also handle cash?
- \*7. Are documents supporting recorded credit adjustments checked or tested subsequently

by persons who do not also handle cash (if so, explain briefly)?

8. Is a daily record maintained summarizing loan transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger account entries?
9. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
10. Are two authorized signatures required to effect a status change in an individual customer account?
11. Is an exception report produced and reviewed by operating management that encompasses extensions, renewals, or any factors that would result in a change in customer account status?
12. Do customer account records clearly indicate accounts which have been renewed or extended?

## **LOAN INTEREST**

13. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
14. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

## **COLLATERAL**

15. Are multicopy, prenumbered records maintained that:
  - a. Detail the complete description of collateral pledged?
  - b. Are typed or completed in ink?
  - c. Are signed by the customer?
16. Are receipts issued to customers covering each item of collateral deposited?
17. Are the functions of receiving and releasing collateral to borrowers and of making

- entries in the collateral register performed by different employees?
18. Is negotiable collateral held under joint custody?
  19. Is all collateral for a single loan maintained in a separate file?
  20. Are receipts obtained and filed for released collateral?
  21. Is a record maintained of entry to the collateral vault?
  22. Are controls in effect on collateral so that:
    - a. When the bank's own savings pass-books are held as collateral, the savings department is notified and the account is so noted on the deposit ledger?
    - b. Descriptions of motor vehicles, as set forth on the certificate of title and insurance policies, are checked to the chattel mortgages or other appropriate documents granting security interest in the vehicle?
    - c. An insurance maturity tickler file is maintained?
    - d. Procedures are in effect to make sure single-interest insurance coverage is obtained in case regular insurance is cancelled or expires?
    - e. All insurance policies on file include a loss payable clause in favor of the bank?
    - f. Filings are made on all security agreements?
    - g. When a judgment action is returned involving real property, are supporting lien searches and property appraisals performed?
  23. Are control records maintained which identify loans secured by junior liens on real estate?
  24. Do those records indicate the current balance for loans secured by superior liens on the same property?
  - d. Monthly summaries of the total paper discounted and outstanding for each dealer prepared and reviewed?
  - e. Dealer lines reaffirmed at least annually?
  - f. Required documents on file in connection with the establishment of each dealer line?
  - g. Signed extension agreements obtained from dealers before extending accounts originally discounted on a repurchase agreement or other recourse basis?
  - h. Checks made to see that downpayment amounts do not misrepresent the sales price?
  - i. Procedures in effect to prevent the dealer from making late payments?
  - j. Prohibitions against bringing loans current by charges to dealer's reserve accounts in effect?
  - k. Selling prices, as listed by the dealer, verified?
  - l. Overdrafts prohibited in the dealer reserve and holdback accounts?
  - m. Procedures in effect to have the title application controlled by other than the purchaser?
  - n. Credit checks on borrowers performed independently of the dealer or are the dealer's credit checks independently verified?
  - o. Are delinquencies verified directly with the customers?

## DISCOUNTED LEASING PAPER

26. If the bank discounts leasing paper:
  - a. Are separate controls maintained or can they be easily generated?
  - b. Are payments made directly to the bank?
  - c. If the lessor is permitted to accept payments, are controls established or audits of lessor's books conducted (if so, explain briefly)?
  - d. Are monthly summaries of total paper discounted for each lessor prepared and reviewed?
  - e. Are lines for each lessor reaffirmed at least annually?
  - f. If fleet leasing or blanket purchase of leasing paper is handled, is a master lease required and properly recorded?
  - g. Are checks made to see that value of leased goods is not less than amount advanced?

## DEALER LOANS

25. On dealer loans, are:
  - a. Separate controls maintained or can they be easily generated?
  - b. Payments made directly to the bank and not through the dealer?
  - c. If coupon books are used in connection with loans, are they mailed to the borrowers, as opposed to the dealer?

- h. Is lease paper screened for credit quality of lessee?
- i. Are lease terms and payment amounts required to be adequate to liquidate the debt in full?

## REPOSSESSIONS

27. Are procedures established on repossessions so that:
- a. Management takes timely action to receive full advantage of any dealer endorsement or repurchase agreement?
  - b. Notice of intention to sell is mailed to all parties liable on the account?
  - c. Bids are required before sale of the item?
  - d. Bids are retained in the borrower's credit file?
  - e. Open repossessions are physically checked monthly?
  - f. Surplus funds received from the sale of a repossession are mailed back to the borrower in the form of a cashier's check?
  - g. Any deficiency balance remaining after sale of repossession is charged off?
  - h. Bill of sale is properly completed and signed by an officer?
  - i. Separate general ledger control is maintained?

## OTHER

28. Are collection policies established so that:
- a. Delinquent notice is sent prior to a loan becoming 30 days past due?
  - b. Collection effort is intensified when a loan becomes two payments past due?
  - c. Records of collection efforts are maintained in the customer's file?
  - d. Field or outside collectors are under the supervision of an officer and are required to submit progress reports?
  - e. All collections are acknowledged on multicopy prenumbered forms?
  - f. All documents which are held outside the regular files, pertaining to installment loans under collection, are evidenced by a transmittal sheet and receipt?
  - g. Delinquency lists are generated on a timely basis (indicate frequency\_\_\_\_\_)?

29. Is an operating review system in place that:
- a. Determines that duties are properly segregated and that loan officers are prohibited from processing loan payments?
  - b. Recomputes the amount of credit life and accident and health insurance on new loans?
  - c. Recomputes the amount of discount on new loans?
  - d. Recomputes the rebates on prepaid loans?
  - e. Test checks daily transactions to subsequent general ledger postings?
  - f. Reviews new loan documentation?
  - g. Reviews all information contained in reports being submitted to the board of directors or any committee thereof for errors or omissions?
  - h. Conducts a periodic review of income accruals for accuracy?
  - i. Reviews entries to unearned discount or income accounts?
  - j. Reviews all charged-off loans for proper approval?
  - k. Periodically reconciles charged-off notes to controls?
  - l. Reviews dealer's reserve and holdback agreements and periodically determines the adequacy of the balances in the deposit account?
  - m. Periodically verifies dealer reserve balances?
  - n. Determines that payments are accurately and promptly posted?
  - o. Reviews collection or reversal of late charges?
  - p. Determines that extension fees are collected on all extended loans?
  - q. Determines that discounted dealer paper is properly endorsed?
  - r. Determines that discounted dealer paper is within established guidelines?
  - s. Reviews compliance with laws and regulations?
  - t. Reviews trial balance reconciliations to the general ledger?

## CONCLUSION

30. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in

- areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
31. Based on a composite evaluation (as evidenced by answers to the foregoing questions), internal control is considered (adequate/inadequate).